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APB accounting principles: volume 2: Original pronouncements as of February 1, 1971

American Institute of Certified Public Accountants. Accounting Principles Board

APB ACCOUNTING PRINCIPLES

• Original Pronouncements

AS OF FEBRUARY 1, 1971

VOLUME TWO

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

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APB ACCOUNTING PRINCIPLES

• *Original Pronouncements*

AS OF FEBRUARY 1, 1971

VOLUME TWO

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• *Original Pronouncements*

ACCOUNTING RESEARCH BULLETINS

. . . the full text of Accounting Research Bulletins issued by the Committee on Accounting Procedure . . .

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FOREWORD

SEPTEMBER, 1961

The committee on accounting procedure and the committee on terminology of the American Institute of Certified Public Accountants were superseded on September 1, 1959, by the Accounting Principles Board. At its first meeting, on September 11, 1959, the Board approved the following resolution:

> The Accounting Principles Board of the American Institute of Certified Public Accountants on September 1, 1959, assumed the responsibilities of the former committees on accounting procedure and on terminology. During its existence, the committee on accounting procedure issued a series of accounting research bulletins and the committee on terminology issued a series of accounting terminology bulletins. In 1953, the first forty-two of the accounting research bulletins were revised, restated, or withdrawn and appeared as Accounting Research Bulletin No. 43 and Accounting Terminology Bulletin No. 1. Since 1953, other bulletins have been issued, the last accounting research bulletin being No. 51 and the last terminology bulletin being No. 4.
>
> The Accounting Principles Board has the authority, as did the predecessor committees, to review and revise any of these bulletins and it plans to take such action from time to time.
>
> Pending such action and in order to prevent any misunderstanding meanwhile as to the status of the existing accounting research and terminology bulletins, the Accounting Principles Board now makes public announcement that these bulletins should be considered as continuing in force with the same degree of authority as before.

Included in this volume[1] are Accounting Research Bulletins No. 43 (a revision and restatement of previous Bulletins) and Bulletins Nos. 44 to 51, and Accounting Terminology Bulletins Nos. 1 to 4[2] in the form in which they were originally published. These are all of the bulletins which were in force at September 1, 1959, and, up to the date of this publication,[3] none of them has been revised or revoked by any action of the Accounting Principles Board.

[1] Accounting Research and Terminology Bulletins, Final Edition, 1961, American Institute of Certified Public Accountants.

[2] These are reproduced herein in the division entitled "Accounting Terminology Bulletins" beginning on page 9501.

[3] September, 1961.

Accounting Research Bulletin No. 43

RESTATEMENT AND REVISION OF ACCOUNTING RESEARCH BULLETINS

JUNE, 1953

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Preface

Since its organization the American Institute of Accountants, aware of divergences in accounting procedures and of an increasing interest by the public in financial reporting, has given consideration to problems raised by these divergences. Its studies led it, in 1932, to make certain recommendations to the New York Stock Exchange which were adopted by the Institute in 1934. Further consideration developed into a program of research and the publication of opinions, beginning in 1938, in a series of Accounting Research Bulletins.

Forty-two bulletins were issued during the period from 1939 to 1953. Eight of these were reports of the committee on terminology. The other 34 were the result of research by the committee on accounting procedure directed to those segments of accounting practice where problems were most demanding and with which business and the accounting profession were most concerned at the time.

Some of these studies were undertaken to meet new business or economic developments. Some arose out of the war which ended in 1945 and the problems following in its wake. Certain of the bulletins were amended, superseded, or withdrawn as changing conditions affected their usefulness.

The purposes of this restatement are to eliminate what is no longer applicable, to condense and clarify what continues to be of value, to revise where changed views require revision, and to arrange the retained material by subjects rather than in the order of issuance. The terminology bulletins are not included. They are being published separately.

The committee has made some changes of substance, which are summarized in appendix B.

The several chapters and subchapters of this restatement and revision are to be regarded as a cancellation and replacement of Accounting Research Bulletins 1 through 42, excepting the terminology bulletins included in that series, which are being replaced by a separate publication.

Although the committee has approved the objective of finding a better term than the word *surplus* for use in published financial statements, it has used *surplus* herein as being a technical term well understood among accountants, to whom its pronouncements are primarily directed.

Committee on Accounting Procedure

June, 1953

Each section of Accounting Research Bulletin No. 43, entitled Restatement and Revision of Accounting Research Bulletins, *was separately adopted by the assenting votes of the twenty members of the committee except to the extent that dissents, or assents with qualification, are noted at the close of each section. Publication of the bulletin as a whole was approved by the assenting votes of all members of the committee, one of whom, Mr. Andrews, assented with qualification.*

Mr. Andrews assents to the publication of this bulletin only to the extent that it constitutes, with no changes in meaning other than those set forth in appendix B, a restatement of the bulletins previously issued by the committee and not mentioned in appendix C as having been omitted. He dissents from the statement contained in the preface that this bulletin is to be regarded as a cancellation of the previously issued bulletins; he regards it as beyond the power of the committee to cancel its previous statements, which in his view inescapably remain authoritative expressions as at the date of their utterance.

Committee on Accounting Procedure (1952-1953)

PAUL K. KNIGHT
Chairman
FREDERICK B. ANDREWS
FRANK S. CALKINS
H. A. FINNEY
ROY GODFREY
THOMAS G. HIGGINS
JOHN A. LINDQUIST
PERRY MASON
EDWARD F. MCCORMACK
JOHN PEOPLES
MAURICE E. PELOUBET
JOHN W. QUEENAN
WALTER L. SCHAFFER
C. AUBREY SMITH
C. OLIVER WELLINGTON
WILLIAM W. WERNTZ
EDWARD B. WILCOX
RAYMOND D. WILLARD
ROBERT W. WILLIAMS
KARL R. ZIMMERMANN

CARMAN G. BLOUGH,
Director of Research

Introduction

ACCOUNTING AND THE CORPORATE SYSTEM

1. Accounting is essential to the effective functioning of any business organization, particularly the corporate form. The test of the corporate system and of the special phase of it represented by corporate accounting ultimately lies in the results which are produced. These results must be judged from the standpoint of society as a whole—not merely from that of any one group of interested persons.

2. The uses to which the corporate system is put and the controls to which it is subject change from time to time, and all parts of the machinery must be adapted to meet changes as they occur. In the past fifty years there has been an increasing use of the corporate system for the purpose of converting into readily transferable form the ownership of large, complex, and more or less permanent business enterprises. This evolution has brought in its train certain uses of the processes of law and accounting which have led to the creation of new controls, revisions of the laws, and reconsideration of accounting procedures.

3. As a result of this development, the problems in the field of accounting have increasingly come to be considered from the standpoint of the buyer or seller of an interest in an enterprise, with consequent increased recognition of the significance of the income statement and a tendency to restrict narrowly charges and credits to surplus. The fairest possible presentation of periodic net income, with neither material overstatement nor understatement, is important, since the results of operations are significant not only to prospective buyers of an interest in the enterprise but also to prospective sellers. With the increasing importance of the income statement there has been a tendency to regard the balance sheet as the connecting link between successive income statements; however this concept should not obscure the fact that the balance sheet has significant uses of its own.

4. This evolution has also led to a demand for a larger degree of uniformity in accounting. *Uniformity* has usually connoted similar treatment of the same item occurring in many cases, in which sense it runs the risk of concealing important differences among cases. Another sense of the word would require that different authorities working independently on the same case should reach the same conclusions. Although uniformity is a worthwhile goal, it should not be pursued to the exclusion of other

benefits. Changes of emphasis and objective as well as changes in conditions under which business operates have led, and doubtless will continue to lead, to the adoption of new accounting procedures. Consequently diversity of practice may continue as new practices are adopted before old ones are completely discarded.

APPLICABILITY OF COMMITTEE OPINIONS

5. The principal objective of the committee has been to narrow areas of difference and inconsistency in accounting practices, and to further the development and recognition of generally accepted accounting principles, through the issuance of opinions and recommendations that would serve as criteria for determining the suitability of accounting practices reflected in financial statements and representations of commercial and industrial companies. In this endeavor, the committee has considered the interpretation and application of such principles as appeared to it to be pertinent to particular accounting problems. The committee has not directed its attention to accounting problems or procedures of religious, charitable, scientific, educational, and similar non-profit institutions, municipalities, professional firms, and the like. Accordingly, except where there is a specific statement of a different intent by the committee, its opinions and recommendations are directed primarily to business enterprises organized for profit.

VOTING PROCEDURE IN ADOPTING OPINIONS

6. The committee regards the representative character and general acceptability of its opinions as of the highest importance, and to that end has adopted the following procedures:

(a) Any opinion or recommendation before issuance is submitted in final form to all members of the committee either at a meeting or by mail.

(b) No such opinion or recommendation is issued unless it has received the approval of two-thirds of the entire committee.

(c) Any member of the committee dissenting from an opinion or recommendation issued under the preceding rule is entitled to have the fact of his dissent and his reasons therefor recorded in the document in which the opinion or recommendation is presented.

7. Before reaching its conclusions, the committee gives careful consideration to prior opinions, to prevailing practices, and to the views of professional and other bodies concerned with accounting procedures.

AUTHORITY OF OPINIONS

8. Except in cases in which formal adoption by the Institute membership has been asked and secured, the authority of opinions reached by the committee rests upon their general acceptability. The committee recognizes that in extraordinary cases fair presentation and justice to all parties at interest may require exceptional treatment. But the burden of justifying departure from accepted procedures, to the extent that they are evidenced in committee opinions, must be assumed by those who adopt another treatment.

9. The committee contemplates that its opinions will have application only to items material and significant in the relative circumstances. It considers that items of little or no consequence may be dealt with as expediency may suggest. However, freedom to deal expediently with immaterial items should not extend to a group of items whose cumulative effect in any one financial statement may be material and significant.

OPINIONS NOT RETROACTIVE

10. No opinion issued by the committee is intended to have a retroactive effect unless it contains a statement of such intention. Thus an opinion will ordinarily have no application to a transaction arising prior to its publication, nor to transactions in process of completion at the time of publication. But while the committee considers it inequitable to make its statements retroactive, it does not wish to discourage the revision of past accounts in an individual case if it appears to be desirable in the circumstances.

THE COMPANY AND ITS AUDITORS

11. Underlying all committee opinions is the fact that the accounts of a company are primarily the responsibility of management. The responsibility of the auditor is to express his opinion concerning the financial statements and to state clearly such explanations, amplifications, disagreement, or disapproval as he deems appropriate. While opinions of the committee are addressed particularly to certified public accountants whose problem it is to decide what they may properly report, the committee recommends similar application of the procedures mentioned herein by those who prepare the accounts and financial statements.

CHAPTER 1 Prior Opinions

Section A—Rules Adopted by Membership

Below are reprinted the six rules adopted by the membership of the Institute in 1934, the first five of which had been recommended in 1932 to the New York Stock Exchange by the Institute's committee on cooperation with stock exchanges.

1. Unrealized profit should not be credited to income account of the corporation either directly or indirectly, through the medium of charging against such unrealized profits amounts which would ordinarily fall to be charged against income account. Profit is deemed to be realized when a sale in the ordinary course of business is effected, unless the circumstances are such that the collection of the sale price is not reasonably assured. An exception to the general rule may be made in respect of inventories in industries (such as packing-house industry) in which owing to the impossibility of determining costs it is a trade custom to take inventories at net selling prices, which may exceed cost.

2. Capital surplus, however created, should not be used to relieve the income account of the current or future years of charges which would otherwise fall to be made thereagainst. This rule might be subject to the exception that where, upon reorganization, a reorganized company would be relieved of charges which would require to be made against income if the existing corporation were continued, it might be regarded as permissible to accomplish the same result without reorganization provided the facts were as fully revealed to and the action as formally approved by the shareholders as in reorganization.

3. Earned surplus of a subsidiary company created prior to acquisition does not form a part of the consolidated earned surplus of the parent company and subsidiaries; nor can any dividend declared out of such surplus properly be credited to the income account of the parent company.

4. While it is perhaps in some circumstances permissible to show stock of a corporation held in its own treasury as an asset, if adequately disclosed, the dividends on stock so held should not be treated as a credit to the income account of the company.

5. Notes or accounts receivable due from officers, employees, or affiliated companies must be shown separately and not included under a general heading such as notes receivable or accounts receivable.

6. If capital stock is issued nominally for the acquisition of property and it appears that at about the same time, and pursuant to a previous agreement or understanding, some portion of the stock so issued is donated to the corporation, it is not permissible to treat the par value of the stock nominally issued for the property as the cost of that property. If stock so donated is subsequently sold, it is not permissible to treat the proceeds as a credit to surplus of the corporation.

Section B—Opinion Issued by Predecessor Committee

1. Following an inquiry made by the New York Stock Exchange, a predecessor committee on accounting procedure in 1938 issued the following report:

"PROFITS OR LOSSES ON TREASURY STOCK"

2. "The executive committee of the American Institute of Accountants has directed that the following report of the committee on accounting procedure, which it received at a meeting on April 8, 1938, be published, without approval or disapproval of the committee, for the information of members of the Institute:

To the Executive Committee,
American Institute of Accountants:

3. "This committee has had under consideration the question regarding treatment of purchase and sale by a corporation of its own stock, which was raised during 1937 by the New York Stock Exchange with the Institute's special committee on cooperation with stock exchanges.

4. "As a result of discussions which then took place, the special committee on cooperation with stock exchanges made a report which was approved by the committee on accounting procedure and the executive committee, and a copy of which was furnished to the committee on stock list of the New York Stock Exchange. The question raised was stated in the following form:

5. "'Should the difference between the purchase and resale prices of a corporation's own common stock be reflected in earned surplus (either directly or through inclusion in the income account) or should such difference be reflected in capital surplus?'

6. "The opinion of the special committee on cooperation with stock exchanges reads in part as follows:

7. "'Apparently there is general agreement that the difference between the purchase price and the stated value of a corporation's common stock purchased and retired should be reflected in capital surplus. Your committee believes that while the net asset value of the shares of common stock outstanding in the hands of the public may be increased or decreased by such purchase and retirement, such transactions relate to the capital of the corporation and do not give rise to corporate profits or losses. Your committee can see no essential difference between (a) the purchase and retirement of a corporation's own common stock and the subsequent issue of common shares, and (b) the purchase and resale of its own common stock.'

8. "This committee is in agreement with the views thus expressed; it is aware that such transactions have been held to give rise to taxable income, but it does not feel that such decisions constitute any bar to the application of correct accounting procedure as above outlined.

9. "The special committee on cooperation with stock exchanges continued and concluded its report with the following statement:

10. "'Accordingly, although your committee recognizes that there may be cases where the transactions involved are so inconsequential as to be immaterial, it does not believe that, as a broad general principle, such transactions should be reflected in earned surplus (either directly or through inclusion in the income account).'

11. "This committee agrees with the special committee on cooperation with stock exchanges, but thinks it desirable to point out that the qualification should not be applied to any transaction which, although in itself inconsiderable in amount, is a part of a series of transactions which in the aggregate are of substantial importance.

12. "This committee recommends that the views expressed be circulated for the information of members of the Institute."

CHAPTER 2 Form of Statements

Section A—Comparative Financial Statements

1. The presentation of comparative financial statements in annual and other reports enhances the usefulness of such reports and brings out more clearly the nature and trends of current changes affecting the enterprise. Such presentation emphasizes the fact that statements for a series of periods are far more significant than those for a single period and that the accounts for one period are but an instalment of what is essentially a continuous history.

2. In any one year it is ordinarily desirable that the balance sheet, the income statement, and the surplus statement be

given for one or more preceding years as well as for the current year. Footnotes, explanations, and accountants' qualifications which appeared on the statements for the preceding years should be repeated, or at least referred to, in the comparative statements to the extent that they continue to be of significance. If, because of reclassifications or for other reasons, changes have occurred in the manner of or basis for presenting corresponding items for two or more periods, information should be furnished which will explain the change. This procedure is in conformity with the well recognized principle that any change in practice which affects comparability should be disclosed.

3. It is necessary that prior-year figures shown for comparative purposes be in fact comparable with those shown for the most recent period, or that any exceptions to comparability be clearly brought out.

4. Circumstances vary so greatly that it is not practicable to deal here specifically with all situations. The independent accountant should, however, make very clear what statements are included within the scope of his report.

Section B—Combined Statement of Income and Earned Surplus

1. Attention has already been called in the introduction to the increased significance attributed to the income statement by users of financial statements and to the general tendency to regard the balance sheet as the connecting link between successive income statements. It therefore becomes important to consider the problems presented by the practice of combining the annual income statement with the statement of earned surplus.

2. The combining of these two statements, where possible, will often be found to be convenient and desirable. Where this presentation is contemplated, however, certain considerations should be borne in mind if undesirable consequences are to be avoided.

ADVANTAGES OF THE COMBINED STATEMENT

3. Over the years it is plainly desirable that all costs, expenses, and losses, and all profits of a business, other than decreases or increases arising directly from its capital-stock transactions, be included in the determination of income. If this principle could in practice be carried out perfectly, there would be no charges or credits to earned surplus except those relating to distributions and appropriations of final net income. This is an ideal upon which all may agree, but because of conditions impossible to foresee it often fails of attainment. From time to time charges and credits are made to surplus which clearly affect the cumulative total of income for a series of years, although their exclusion from the income statement of a single year is justifiable. There is danger that unless the two statements are closely connected such items will be overlooked, or at any rate not given full weight, in any attempt on the part of the reader to compute a company's long-run income or its income-earning capacity.

4. There is a marked tendency to exaggerate the significance of the net income for a single year, particularly the degree to which the net income can be identified exclusively with that year. In so far as the combined form calls attention to the character of the income statement as a tentative instalment in the long-time financial results it serves a useful purpose.

5. To summarize, the combined income and earned surplus statement serves the purpose of showing in one statement both the earnings applicable to the particular period and modifications of earned surplus on a long-run basis. It distinguishes current charges and credits related to a company's more usual or typical business operations from material extraordinary charges and credits[1] which may have arisen during the period by placing them in different sections of a continuous statement.

DISADVANTAGES AND LIMITATIONS

6. In the combined statement, net income for the year appears somewhere within the statement and not at the end. Such wording and arrangement should be used as will

[1] See chapter 8, paragraphs 11, 12, and 13.

make this item unmistakably clear and leave the reader in no doubt as to the point at which the net income has been determined.

7. While it is true that the net income amount, when expressed as earnings per share, is often given undue prominence and its significance exaggerated, there nevertheless remain the responsibility for determination of net income by sound methods and the duty to show it clearly. The adoption of the combined statement provides no excuse for less care in distinguishing charges and credits to income from charges and credits to surplus than would be required if separate statements of income and surplus were presented. Failure to exercise care in the use of this form of statement would immediately discredit it.

CHAPTER 3 Working Capital

Section A—Current Assets and Current Liabilities

1. The working capital of a borrower has always been of prime interest to grantors of credit; and bond indentures, credit agreements, and preferred stock agreements commonly contain provisions restricting corporate actions which would effect a reduction or impairment of working capital. Many such contracts forego precise or uniform definitions and merely provide that current assets and current liabilities shall be determined in accordance with generally accepted accounting principles. Considerable variation and inconsistency exists, however, with respect to their classification and display in financial statements. In this section the committee discusses the nature of current assets and current liabilities with a view toward a more useful presentation thereof in financial statements.

2. The committee believes that, in the past, definitions of current assets have tended to be overly concerned with whether the assets may be immediately realizable. The discussion which follows takes cognizance of the tendency for creditors to rely more upon the ability of debtors to pay their obligations out of the proceeds of current operations and less upon the debtor's ability to pay in case of liquidation. It should be emphasized that financial statements of a going concern are prepared on the assumption that the company will continue in business. Accordingly, the views expressed in this section represent a departure from any narrow definition or strict *one year* interpretation of either current assets or current liabilities; the objective is to relate the criteria developed to the operating cycle of a business.

3. Financial position, as it is reflected by the records and accounts from which the statement is prepared, is revealed in a presentation of the assets and liabilities of the enterprise. In the statements of manufacturing, trading, and service enterprises these assets and liabilities are generally classified and segregated; if they are classified logically, summations or totals of the *current* or *circulating* or *working* assets, hereinafter referred to as *current assets,* and of obligations currently payable, designated as *current liabilities,* will permit the ready determination of working capital. *Working capital,* sometimes called *net working capital,* is represented by the excess of current assets over current liabilities and identifies the relatively liquid portion of total enterprise capital which constitutes a margin or buffer for meeting obligations within the ordinary operating cycle of the business. If the conventions of accounting relative to the identification and presentation of current assets and current liabilities are made logical and consistent, the amounts, bases of valuation, and composition of such assets and liabilities and their relation to the total assets or capital employed will provide valuable data for credit and management purposes and afford a sound basis for comparisons from year to year. It is recognized that there may be exceptions, in special cases, to certain of the inclusions and exclusions as set forth in this section. When such exceptions occur they should be accorded the treatment merited in the particular circumstances under the general principles outlined herein.

4. For accounting purposes, the term *current assets* is used to designate cash and other assets or resources commonly identified as those which are reasonably expected to be realized in cash or sold or consumed during the normal operating cycle of the business. Thus the term comprehends in general such resources as (a) cash available for current operations and items which are the equivalent of cash; (b) inventories of merchandise, raw materials, goods in process,

finished goods, operating supplies, and ordinary maintenance material and parts; (c) trade accounts, notes, and acceptances receivable; (d) receivables from officers, employees, affiliates, and others, if collectible in the ordinary course of business within a year; (e) instalment or deferred accounts and notes receivable if they conform generally to normal trade practices and terms within the business; (f) marketable securities representing the investment of cash available for current operations; and (g) prepaid expenses such as insurance, interest, rents, taxes, unused royalties, current paid advertising service not yet received, and operating supplies. Prepaid expenses are not current assets in the sense that they will be converted into cash but in the sense that, if not paid in advance, they would require the use of current assets during the operating cycle.

5. The ordinary operations of a business involve a circulation of capital within the current asset group. Cash is expended for materials, finished parts, operating supplies, labor, and other factory services, and such expenditures are accumulated as inventory cost. Inventory costs, upon sale of the products to which such costs attach, are converted into trade receivables and ultimately into cash again. The average time intervening between the acquisition of materials or services entering this process and the final cash realization constitutes an *operating cycle*. A one-year time period is to be used as a basis for the segregation of current assets in cases where there are several operating cycles occurring within a year. However, where the period of the operating cycle is more than twelve months, as in, for instance, the tobacco, distillery, and lumber businesses, the longer period should be used. Where a particular business has no clearly defined operating cycle, the one-year rule should govern.

6. This concept of the nature of current assets contemplates the exclusion from that classification of such resources as: (a) cash and claims to cash which are restricted as to withdrawal or use for other than current operations, are designated for expenditure in the acquisition or construction of noncurrent assets, or are segregated[1] for the liquidation of long-term debts; (b) investments in securities (whether marketable or not) or advances which have been made for the purposes of control, affiliation, or other continuing business advantage; (c) receivables arising from unusual transactions (such as the sale of capital assets, or loans or advances to affiliates, officers, or employees) which are not expected to be collected within twelve months; (d) cash surrender value of life insurance policies; (e) land and other natural resources; (f) depreciable assets; and (g) long-term prepayments which are fairly chargeable to the operations of several years, or deferred charges such as unamortized debt discount and expense, bonus payments under a long-term lease, costs of rearrangement of factory layout or removal to a new location, and certain types of research and development costs.

7. The term *current liabilities* is used principally to designate obligations whose liquidation is reasonably expected to require the use of existing resources properly classifiable as current assets, or the creation of other current liabilities. As a balance-sheet category, the classification is intended to include obligations for items which have entered into the operating cycle, such as payables incurred in the acquisition of materials and supplies to be used in the production of goods or in providing services to be offered for sale; collections received in advance of the delivery of goods or performance of services;[2] and debts which arise from operations directly related to the operating cycle, such as accruals for wages, salaries, commissions, rentals, royalties, and income and other taxes. Other liabilities whose regular and ordinary liquidation is expected to occur within a relatively short period of time, usually twelve months, are also intended for inclusion, such as short-term debts arising from the acquisition of capital assets, serial maturities of long-term obligations, amounts required to be expended within one year under sinking fund provisions, and agency obligations arising from the collection or acceptance of cash or other assets for the account of third persons.[3]

[1] Even though not actually set aside in special accounts, funds that are clearly to be used in the near future for the liquidation of long-term debts, payments to sinking funds, or for similar purposes should also, under this concept, be excluded from current assets. However, where such funds are considered to offset maturing debt which has properly been set up as a current liability, they may be included within the current asset classification.

[2] Examples of such current liabilities are obligations resulting from advance collections on ticket sales, which will normally be liquidated in the ordinary course of business by the delivery of services. On the contrary, obligations representing long-term deferments of the delivery of goods or services would not be shown as current liabilities. Examples of the latter are the issuance of a long-term warranty or the advance receipt by a lessor of rental for the final period of a ten-year lease as a condition to execution of the lease agreement.

[3] Loans accompanied by pledge of life insurance policies would be classified as current lia-

8. This concept of current liabilities would include estimated or accrued amounts which are expected to be required to cover expenditures within the year for known obligations (a) the amount of which can be determined only approximately (as in the case of provisions for accruing bonus payments) or (b) where the specific person or persons to whom payment will be made cannot as yet be designated (as in the case of estimated costs to be incurred in connection with guaranteed servicing or repair of products already sold). The current liability classification, however, is not intended to include a contractual obligation falling due at an early date which is expected to be refunded,[4] or debts to be liquidated by funds which have been accumulated in accounts of a type not properly classified as current assets, or long-term obligations incurred to provide increased amounts of working capital for long periods. When the amounts of the periodic payments of an obligation are, by contract, measured by current transactions, as for example by rents or revenues received in the case of equipment trust certificates or by the depletion of natural resources in the case of property obligations, the portion of the total obligation to be included as a current liability should be that representing the amount accrued at the balance-sheet date.

9. The amounts at which various current assets are carried do not always represent their present realizable cash values. Accounts receivable net of allowances for uncollectible accounts, and for unearned discounts where unearned discounts are considered, are effectively stated at the amount of cash estimated as realizable. However, practice varies with respect to the carrying basis for current assets such as marketable securities and inventories. In the case of marketable securities where market value is less than cost by a substantial amount and it is evident that the decline in market value is not due to a mere temporary condition, the amount to be included as a current asset should not exceed the market value. The basis for carrying inventories is stated in chapter 4. It is important that the amounts at which current assets are stated be supplemented by information which reveals, for temporary investments, their market value at the balance-sheet date, and for the various classifications of inventory items, the basis upon which their amounts are stated and, where practicable, indication of the method of determining the cost—e.g., *average cost, first-in first-out, last-in first-out,* etc.

One member of the committee, Mr. Mason, assented with qualification to adoption of section (a) of chapter 3.

Mr. Mason does not accept the view implied in paragraph 6 that unamortized debt discount is an asset. Also, referring to paragraph 9, he believes that the market value is the most significant figure in connection with marketable securities held as temporary investments of cash, and would prefer to show such securities in the accounts at their market value, whether greater or less than cost. He would accept as an alternative the use of cost in the accounts with market value shown parenthetically in the balance sheet.

Section B—Application of United States Government Securities Against Liabilities for Federal Taxes on Income

1. It is a general principle of accounting that the offsetting of assets and liabilities in the balance sheet is improper except where a right of set-off exists. An example of such exception was the showing of United States Treasury Tax Notes, Tax Series A-1943 and B-1943, as a deduction from the liability for federal taxes on income, which the committee approved in 1942.

2. In view of the special nature of the terms of the 1943 tax notes, the intention of the purchaser to use them to pay federal income taxes could be assumed, since he

bilities when, by their terms or by intent, they are to be repaid within twelve months. The pledging of life insurance policies does not affect the classification of the asset any more than does the pledging of receivables, inventories, real estate, or other assets as collateral for a short-term loan. However, when a loan on a life insurance policy is obtained from the insurance company with the intent that it will not be paid but will be liquidated by deduction from the proceeds of the policy upon maturity or cancellation, the obligation should be excluded from current liabilities.

[4] There should, however, be full disclosure that such obligation has been omitted from the current liabilities and a statement of the reason for such omission should be given. Cf note 1.

received no interest or other advantage unless they were so used. Some purchasers doubtless viewed their purchase of the notes as being, to all intents and purposes, an advance payment of the taxes.

3. In the absence of evidence of a contrary intent, it was considered acceptable, and in accordance with good accounting practice, to show the notes in the current liability section of the balance sheet as a deduction from federal taxes on income in an amount not to exceed the accrued liability for such taxes. The full amount of the accrued liability was to be shown with a deduction for the tax payment value of the notes at the date of the balance sheet.

4. It also was recognized as clearly proper to show the notes in the current asset section of the balance sheet as any other temporary investments are shown. If at the balance-sheet date or at the date of the independent auditor's report there was evidence that the original intent was changed, the notes were to be shown in the current asset section of the balance sheet.

5. Government securities having restrictive terms similar to those contained in the 1943 tax series notes are no longer issued, although certain other types of government securities have since been issued which are acceptable in payment of liabilities for federal taxes on income. However, because of the effect on the current position of large tax accruals and the related accumulations of liquid assets to meet such liabilities, many companies have adopted the practice of acquiring and holding government securities of various issues in amounts related to the estimated tax liability. In their financial statements these companies have often expressed this relationship by showing such securities as a deduction from the tax liability, even though the particular securities were not by their terms acceptable in payment of taxes. If the government securities involved may, by their terms, be surrendered in payment of taxes, the above practice clearly falls within the principle of the permissive exception described in paragraph 1. The committee further believes that the extension of the practice to include the offset of other types of United States government securities, although a deviation from the general rule against offsets, is not so significant a deviation as to call for an exception in an accountant's report on the financial statements.

6. Suggestions have been received that similar considerations may be advanced in favor of the offset of cash or other assets against the income and excess profits tax liability or against other amounts owing to the federal government. In the opinion of the committee, however, any such extension or application of the exception, recognized as to United States government securities and liabilities for federal taxes on income, is not to be regarded as acceptable practice.

One member of the committee, Mr. Calkins, assented with qualification to adoption of section (b) of chapter 3.

Mr. Calkins does not approve the concluding sentence of paragraph 5, which states that the offset of other types of United States Government securities, although a deviation from the general rule against offsets, is not so significant a deviation as to call for an exception in an accountant's report. He believes that the significance of such a deviation is a matter for judgment based on the facts of a particular case; that the broader language of the statement constitutes a condonation of the practice of offsetting against tax liabilities United States Government obligations which are not by their terms acceptable in payment of federal taxes; and that the condonation of such a practice is inconsistent with the opinion of the committee expressed in paragraph 6, with which he agrees, that cash and other assets should not be offset against liabilities for federal taxes.

CHAPTER 4 Inventory Pricing

1. Whenever the operation of a business includes the ownership of a stock of goods, it is necessary for adequate financial accounting purposes that inventories be properly compiled periodically and recorded in the accounts.[1] Such inventories are required

[1] Prudent reliance upon perpetual inventory records is not precluded.

both for the statement of financial position and for the periodic measurement of income.

2. This chapter sets forth the general principles applicable to the pricing of inventories of mercantile and manufacturing enterprises. Its conclusions are not directed to or necessarily applicable to noncommercial businesses or to regulated utilities.

STATEMENT 1

The term *inventory* is used herein to designate the aggregate to those items of tangible personal property which (1) are held for sale in the ordinary course of business, (2) are in process of production for such sale, or (3) are to be currently consumed in the production of goods or services to be available for sale.

Discussion

3. The term *inventory* embraces goods awaiting sale (the merchandise of a trading concern and the finished goods of a manufacturer), goods in the course of production (work in process), and goods to be consumed directly or indirectly in production (raw materials and supplies). This definition of inventories excludes long-term assets subject to depreciation accounting, or goods which, when put into use, will be so classified. The fact that a depreciable asset is retired from regular use and held for sale does not indicate that the item should be classified as part of the inventory. Raw materials and supplies purchased for production may be used or consumed for the construction of long-term assets or other purposes not related to production, but the fact that inventory items representing a small portion of the total may not be absorbed ultimately in the production process does not require separate classification. By trade practice, operating materials and supplies of certain types of companies such as oil producers are usually treated as inventory.

STATEMENT 2

A major objective of accounting for inventories is the proper determination of income through the process of matching appropriate costs against revenues.

Discussion

4. An inventory has financial significance because revenues may be obtained from its sale, or from the sale of the goods or services in whose production it is used. Normally such revenues arise in a continuous repetitive process or cycle of operations by which goods are acquired and sold, and further goods are acquired for additional sales. In accounting for the goods in the inventory at any point of time, the major objective is the matching of appropriate costs against revenues in order that there may be a proper determination of the realized income. Thus, the inventory at any given date is the balance of costs applicable to goods on hand remaining after the matching of absorbed costs with concurrent revenues. This balance is appropriately carried to future periods provided it does not exceed an amount properly chargeable against the revenues expected to be obtained from ultimate disposition of the goods carried forward. In practice, this balance is determined by the process of pricing the articles comprised in the inventory.

STATEMENT 3

The primary basis of accounting for inventories is cost, which has been defined generally as the price paid or consideration given to acquire an asset. As applied to inventories, cost means in principle the sum of the applicable expenditures and charges directly or indirectly incurred in bringing an article to its existing condition and location.

Discussion

5. In keeping with the principle that accounting is primarily based on cost, there is a presumption that inventories should be stated at cost. The definition of cost as applied to inventories is understood to mean acquisition and production cost,[2] and its determination involves many problems. Although principles for the determination of inventory costs may be easily stated, their

[2] In the case of goods which have been written down below cost at the close of a fiscal period, such reduced amount is to be considered the cost for subsequent accounting purposes.

application, particularly to such inventory items as work in process and finished goods, is difficult because of the variety of problems encountered in the allocation of costs and charges. For example, under some circumstances, items such as idle facility expense, excessive spoilage, double freight, and rehandling costs may be so abnormal as to require treatment as current period charges rather than as a portion of the inventory cost. Also, general and administrative expenses should be included as period charges, except for the portion of such expenses that may be clearly related to production and thus constitute a part of inventory costs (product charges). Selling expenses constitute no part of inventory costs. It should also be recognized that the exclusion of all overheads from inventory costs does not constitute an accepted accounting procedure. The exercise of judgment in an individual situation involves a consideration of the adequacy of the procedures of the cost accounting system in use, the soundness of the principles thereof, and their consistent application.

STATEMENT 4

Cost for inventory purposes may be determined under any one of several assumptions as to the flow of cost factors (such as first-in first-out, average, and last-in first-out); the major objective in selecting a method should be to choose the one which, under the circumstances, most clearly reflects periodic income.

Discussion

6. The cost to be matched against revenue from a sale may not be the identified cost of the specific item which is sold, especially in cases in which similar goods are purchased at different times and at different prices. While in some lines of business specific lots are clearly identified from the time of purchase through the time of sale and are costed on this basis, ordinarily the identity of goods is lost between the time of acquisition and the time of sale. In any event, if the materials purchased in various lots are identical and interchangeable, the use of identified cost of the various lots may not produce the most useful financial statements. This fact has resulted in the development of general acceptance of several assumptions with respect to the flow of cost factors (such as *first-in first-out, average*, and *last-in first-out*) to provide practical bases for the measurement of periodic income.[3] In some situations a reversed mark-up procedure of inventory pricing, such as the retail inventory method, may be both practical and appropriate. The business operations in some cases may be such as to make it desirable to apply one of the acceptable methods of determining cost to one portion of the inventory or components thereof and another of the acceptable methods to other portions of the inventory.

7. Although selection of the method should be made on the basis of the individual circumstances, it is obvious that financial statements will be more useful if uniform methods of inventory pricing are adopted by all companies within a given industry.

STATEMENT 5

A departure from the cost basis of pricing the inventory is required when the utility of the goods is no longer as great as its cost. Where there is evidence that the utility of goods, in their disposal in the ordinary course of business, will be less than cost, whether due to physical deterioration, obsolescence, changes in price levels, or other causes, the difference should be recognized as a loss of the current period. This is generally accomplished by stating such goods at a lower level commonly designated as *market*.

Discussion

8. Although the cost basis ordinarily achieves the objective of a proper matching of costs and revenues, under certain circumstances cost may not be the amount properly chargeable against the revenues of future periods. A departure from cost is required in these circumstances because cost is satisfactory only if the utility of the goods has not diminished since their acqui-

[3] Standard costs are acceptable if adjusted at reasonable intervals to reflect current conditions so that at the balance-sheet date standard costs reasonably approximate costs computed under one of the recognized bases. In such cases descriptive language should be used which will express this relationship, as, for instance, "approximate costs determined on the first-in first-out basis," or, if it is desired to mention standard costs, "at standard costs, approximating average costs."

sition; a loss of utility is to be reflected as a charge against the revenues of the period in which it occurs. Thus, in accounting for inventories, a loss should be recognized whenever the utility of goods is impaired by damage, deterioration, obsolescence, changes in price levels, or other causes. The measurement of such losses is accomplished by applying the rule of pricing inventories at *cost or market, whichever is lower.* This provides a practical means of measuring utility and thereby determining the amount of the loss to be recognized and accounted for in the current period.

STATEMENT 6

As used in the phrase *lower of cost or market*[4] the term *market* means current replacement cost (by purchase or by reproduction, as the case may be) except that:

(1) Market should not exceed the net realizable value (i.e., estimated selling price in the ordinary course of business less reasonably predictable costs of completion and disposal); and

(2) Market should not be less than net realizable value reduced by an allowance for an approximately normal profit margin.

Discussion

9. The rule of *cost or market, whichever is lower* is intended to provide a means of measuring the residual usefulness of an inventory expenditure. The term *market* is therefore to be interpreted as indicating utility on the inventory date and may be thought of in terms of the equivalent expenditure which would have to be made in the ordinary course at that date to procure corresponding utility. As a general guide, utility is indicated primarily by the current cost of replacement of the goods as they would be obtained by purchase or reproduction. In applying the rule, however, judgment must always be exercised and no loss should be recognized unless the evidence indicates clearly that a loss has been sustained. There are therefore exceptions to such a standard. Replacement or reproduction prices would not be appropriate as a measure of utility when the estimated sales value, reduced by the costs of completion and disposal, is lower, in which case the realizable value so determined more appropriately measures utility. Furthermore, where the evidence indicates that cost will be recovered with an approximately normal profit upon sale in the ordinary course of business, no loss should be recognized even though replacement or reproduction costs are lower. This might be true, for example, in the case of production under firm sales contracts at fixed prices, or when a reasonable volume of future orders is assured at stable selling prices.

10. Because of the many variations of circumstances encountered in inventory pricing, Statement 6 is intended as a guide rather than a literal rule. It should be applied realistically in the light of the objectives expressed in this chapter and with due regard to the form, content, and composition of the inventory. The committee considers, for example, that the retail inventory method, if adequate markdowns are currently taken, accomplishes the objectives described herein. It also recognizes that, if a business is expected to lose money for a sustained period, the inventory should not be written down to offset a loss inherent in the subsequent operations.

STATEMENT 7

Depending on the character and composition of the inventory, the rule of *cost or market, whichever is lower* may properly be applied either directly to each item or to the total of the inventory (or, in some cases, to the total of the components of each major category). The method should be that which most clearly reflects periodic income.

Discussion

11. The purpose of reducing inventory to *market* is to reflect fairly the income of the period. The most common practice is to apply the *lower of cost or market* rule separately to each item of the inventory. However, if there is only one end-product category the cost utility of the total stock—the inventory in its entirety—may have the

[4] The terms *cost or market, whichever is lower* and *lower of cost or market* are used synonymously in general practice and in this chapter. The committee does not express any preference for either of the two alternatives.

greatest significance for accounting purposes. Accordingly, the reduction of individual items to *market* may not always lead to the most useful result if the utility of the total inventory to the business is not below its cost. This might be the case if selling prices are not affected by temporary or small fluctuations in current costs of purchase or manufacture. Similarly, where more than one major product or operational category exists, the application of the *cost or market, whichever is lower* rule to the total of the items included in such major categories may result in the most useful determination of income.

12. When no loss of income is expected to take place as a result of a reduction of cost prices of certain goods because others forming components of the same general categories of finished products have a market equally in excess of cost, such components need not be adjusted to market to the extent that they are in balanced quantities. Thus, in such cases, the rule of *cost or market, whichever is lower* may be applied directly to the totals of the entire inventory, rather than to the individual inventory items, if they enter into the same category of finished product and if they are in balanced quantities, provided the procedure is applied consistently from year to year.

13. To the extent, however, that the stocks of particular materials or components are excessive in relation to others, the more widely recognized procedure of applying the *lower of cost or market* to the individual items constituting the excess should be followed. This would also apply in cases in which the items enter into the production of unrelated products or products having a material variation in the rate of turnover. Unless an effective method of classifying categories is practicable, the rule should be applied to each item in the inventory.

14. When substantial and unusual losses result from the application of this rule it will frequently be desirable to disclose the amount of the loss in the income statement as a charge separately identified from the consumed inventory costs described as *cost of goods sold*.

STATEMENT 8

The basis of stating inventories must be consistently applied and should be disclosed in the financial statements; whenever a significant change is made therein, there should be disclosure of the nature of the change and, if material, the effect on income.

Discussion

15. While the basis of stating inventories does not affect the over-all gain or loss on the ultimate disposition of inventory items, any inconsistency in the selection or employment of a basis may improperly affect the periodic amounts of income or loss. Because of the common use and importance of periodic statements, a procedure adopted for the treatment of inventory items should be consistently applied in order that the results reported may be fairly allocated as between years. A change of such basis may have an important effect upon the interpretation of the financial statements both before and after that change, and hence, in the event of a change, a full disclosure of its nature and of its effect, if material, upon income should be made.

STATEMENT 9

Only in exceptional cases may inventories properly be stated above cost. For example, precious metals having a fixed monetary value with no substantial cost of marketing may be stated at such monetary value; any other exceptions must be justifiable by inability to determine appropriate approximate costs, immediate marketability at quoted market price, and the characteristic of unit interchangeability. Where goods are stated above cost this fact should be fully disclosed.

Discussion

16. It is generally recognized that income accrues only at the time of sale, and that gains may not be anticipated by reflecting assets at their current sales prices. For certain articles, however, exceptions are permissible. Inventories of gold and silver, when there is an effective government-controlled market at a fixed monetary value, are ordinarily reflected at selling prices. A similar treatment is not uncommon for in-

ventories representing agricultural, mineral, and other products, units of which are interchangeable and have an immediate marketability at quoted prices and for which appropriate costs may be difficult to obtain. Where such inventories are stated at sales prices, they should of course be reduced by expenditures to be incurred in disposal, and the use of such basis should be fully disclosed in the financial statements.

STATEMENT 10

Accrued net losses on firm purchase commitments for goods for inventory, measured in the same way as are inventory losses, should, if material, be recognized in the accounts and the amounts thereof separately disclosed in the income statement.

Discussion

17. The recognition in a current period of losses arising from the decline in the utility of cost expenditures is equally applicable to similar losses which are expected to arise from firm, uncancelable, and unhedged commitments for the future purchase of inventory items. The net loss on such commitments should be measured in the same way as are inventory losses and, if material, should be recognized in the accounts and separately disclosed in the income statement. The utility of such commitments is not impaired, and hence there is no loss, when the amounts to be realized from the disposition of the future inventory items are adequately protected by firm sales contracts or when there are other circumstances which reasonably assure continuing sales without price decline.

One member of the committee, Mr. Wellington, assented with qualification, and two members, Messrs. Mason and Peloubet, dissented to adoption of chapter 4.

Mr. Wellington objects to footnote (2) to statement 3. He believes that an exception should be made for goods costed on the *last-in first-out* (LIFO) basis. In the case of goods costed on all bases other than LIFO the reduced amount (market below cost) is cleared from the accounts through the regular accounting entries of the subsequent period, and if the market price rises to or above the original cost there will be an increased profit in the subsequent period. Accounts kept under the LIFO method should also show a similar increased profit in the subsequent period, which will be shown if the LIFO inventory is restored to its original cost. To do otherwise, as required by footnote (2), is to carry the LIFO inventory, not at the lower of cost or current market, but at the lowest market ever known since the LIFO method was adopted by the company.

Mr. Mason dissents from this chapter because of its acceptance of the inconsistencies inherent in *cost or market whichever is lower*. In his opinion a drop in selling price below cost is no more of a realized loss than a rise above cost is a realized gain under a consistent criterion of realization.

Mr. Peloubet believes it is ordinarily preferable to carry inventory at not less than recoverable cost, and particularly in the case of manufactured or partially manufactured goods which can be sold only in finished form. He recognizes that application of the *cost or market* valuation basis necessitates the shifting of income from one period to another, but objects to unnecessarily accentuating this shift by the use, even limited as it is in this chapter, of reproduction or replacement cost as *market* when such cost is less than net selling price.

CHAPTER 5 Intangible Assets

1. This chapter deals with problems involved in accounting for certain types of assets classified by accountants as intangibles, specifically, those acquired by the issuance of securities or purchased for cash or other consideration. Such assets may be purchased or acquired separately for a specified consideration or may be purchased or acquired, together with other assets, for a lump-sum consideration without specification by either the seller or the purchaser, at the time of purchase, of the portions of the total price which are applicable to the respective assets thus acquired. In dealing with the intangible assets herein considered, important questions arise as to the initial

carrying amount of such assets, the amortization of such amount where their term of existence is definitely limited or problematical, and their write-down or write-off at some later time where there is a substantial and permanent decline in the value of such assets. These questions involve basic accounting principles of balance-sheet presentation and income determination and this chapter is designed to promote a fuller consideration of those principles. It does not, however, deal with the problems of accounting for intangibles developed in the regular course of business by research, experimentation, advertising, or otherwise.

CLASSIFICATION OF INTANGIBLES

2. The intangibles herein considered may be broadly classified as follows:

(a) Those having a term of existence limited by law, regulation, or agreement, or by their nature (such as patents, copyrights, leases, licenses, franchises for a fixed term, and goodwill as to which there is evidence of limited duration);

(b) Those having no such limited term of existence and as to which there is, at the time of acquisition, no indication of limited life (such as goodwill generally, going value, trade names, secret processes, subscription lists, perpetual franchises, and organization costs).

3. The intangibles described above will hereinafter be referred to as type (a) and type (b) intangibles, respectively. The portion of a lump-sum consideration deemed to have been paid for intangible elements when a mixed aggregate of tangible and intangible property is acquired, or the excess of a parent company's investment in the stock of a subsidiary over its equity in the net assets of the subsidiary as shown by the latter's books at the date of acquisition, in so far as that excess would be treated as an intangible in consolidated financial statements of the parent and the subsidiary, may represent intangibles of either type (a) or type (b) or a combination of both.

INITIAL CARRYING AMOUNT

4. The initial amount assigned to all types of intangibles should be cost, in accordance with the generally accepted accounting principle that assets should be stated at cost when they are acquired. In the case of non-cash acquisitions, as, for example, where intangibles are acquired in exchange for securities, cost may be considered as being either the fair value of the consideration given or the fair value of the property or right acquired, whichever is the more clearly evident.

AMORTIZATION OF INTANGIBLES

Type (a)

5. The cost of type (a) intangibles should be amortized by systematic charges in the income statement over the period benefited, as in the case of other assets having a limited period of usefulness. If it becomes evident that the period benefited will be longer or shorter than originally estimated, recognition thereof may take the form of an appropriate decrease or increase in the rate of amortization or, if such increased charges would result in distortion of income, a partial write-down may be made by a charge to earned surplus.

Type (b)

6. When it becomes reasonably evident that the term of existence of a type (b) intangible has become limited and that it has therefore become a type (a) intangible, its cost should be amortized by systematic charges in the income statement over the estimated remaining period of usefulness. If, however, the period of amortization is relatively short so that misleading inferences might be drawn as a result of inclusion of substantial charges in the income statement a partial write-down may be made by a charge to earned surplus,[1] and the rest of the cost may be amortized over the remaining period of usefulness.

7. When a corporation decides that a type (b) intangible may not continue to have value during the entire life of the enterprise it may amortize the cost of such intangible by systematic charges against income despite the fact that there are no present indications of limited existence or loss of value which would indicate that it has become type (a), and despite the fact that expenditures are being made to maintain its value. Such amortization is within the discretion of the company and is not to be regarded as obligatory. The plan

[1] See chapter 8, paragraphs 11, 12, and 13.

of amortization should be reasonable; it should be based on all the surrounding circumstances, including the basic nature of the intangible and the expenditures currently being made for development, experimentation, and sales promotion. Where the intangible is an important income-producing factor and is currently being maintained by advertising or otherwise, the period of amortization should be reasonably long. The procedure should be formally approved and the reason for amortization, the rate used, and the shareholders' or directors' approval thereof should be disclosed in the financial statements.

WRITE-OFF OF INTANGIBLES

8. The cost of type (b) intangibles should be written off when it becomes reasonably evident that they have become worthless. Under such circumstances the amount at which they are carried on the books should be charged off in the income statement or, if the amount is so large that its effect on income may give rise to misleading inferences, it should be charged to earned surplus.[1] In determining whether an investment in type (b) intangibles has become or is likely to become worthless, consideration should be given to the fact that in some cases intangibles acquired by purchase may merge with, or be replaced by, intangibles acquired or developed with respect to other products or lines of business and that in such circumstances the discontinuance of a product or line of business may not in fact indicate loss of value.

LIMITATION ON WRITE-OFF OF INTANGIBLES

9. Lump-sum write-offs of intangibles should not be made to earned surplus immediately after acquisition, nor should intangibles be charged against capital surplus. If not amortized systematically, intangibles should be carried at cost until an event has taken place which indicates a loss or a limitation on the useful life of the intangibles.

PURCHASE OF SUBSIDIARY'S STOCK OR BASKET PURCHASE OF ASSETS

10. A problem arises in cases where a group of intangibles or a mixed aggregate of tangible and intangible property is acquired for a lump-sum consideration, or when the consideration given for a stock investment in a subsidiary is greater than the net assets of such subsidiary applicable thereto, as carried on its books at the date of acquisition. In this latter type of situation there is a presumption that the parent company, in effect, placed a valuation greater than their carrying amount on some of the assets of the subsidiary in arriving at the price it was willing to pay for its investment therein. The parent corporation may have (a) paid amounts in excess of carrying amounts for specific assets of the subsidiary or (b) paid for the general goodwill of the subsidiary. In these cases, if practicable, there should be an allocation, as between tangible and intangible property, of the cost of the mixed aggregate of property or of the excess of a parent's investment over its share of the amount at which the subsidiary carried its net assets on its books at the date of acquisition. Any amount allocated to intangibles should be further allocated to determine, if practicable, a separate cost for each type (a) intangible and for at least the aggregate of all type (b) intangibles. The amounts so allocated to intangibles should thereafter be dealt with in accordance with the procedures outlined in this chapter.

CHAPTER 6 Contingency Reserves

1. The purpose of this chapter is to consider problems which arise in the accounting treatment of two types of reserves whose misuse may be the means of either arbitrarily reducing income or shifting income from one period to another:

(a) General contingency reserves whose purposes are not specific;

(b) Reserves designed to set aside a part of current profits to absorb losses feared or expected in connection with inventories on hand or future purchases of inventory.

2. Charges to provide, either directly or by use of a reserve, for losses due to obsolescence or deterioration of inventory or for

[1] See chapter 8, paragraphs 11, 12, and 13.

reducing an inventory to market, or for reducing an inventory to a recognized basis such as *last-in first-out* or its equivalent in accordance with an announced change in policy to be consistently followed thereafter, are not under consideration here.

3. If a provision for a reserve, made against income, is not properly chargeable to current revenues, net income for the period is understated by the amount of the provision. If a reserve so created is used to relieve the income of subsequent periods of charges that would otherwise be made against it, the income of such subsequent periods is thereby overstated. By use of the reserve in this manner, profit for a given period may be significantly increased or decreased by mere whim. As a result of this practice the integrity of financial statements is impaired, and the statements tend to be misleading.

4. The committee recognizes the character of the income statement as a tentative instalment in the record of long-time financial results, and is aware of the tendency to exaggerate the significance of the net income for a single year.[1] Nevertheless, there still exist the responsibility for determining net income as fairly as possible by sound methods consistently applied and the duty to show it clearly. In accomplishing these objectives, it is deemed desirable to provide, by charges in the current income statement, properly classified, or all foreseeable costs and losses applicable against current revenues, to the extent that they can be measured and allocated to fiscal periods with reasonable approximation.

5. Accordingly, inventories on hand or contracted for should be priced in accordance with principles stated elsewhere by the committee.[2] When inventories which have been priced in accordance with those principles are further written down by a charge to income, either directly or through the use of a reserve, current revenues are not properly matched with applicable costs, and charges to future operations are correspondingly reduced. This process results in the shifting of profits from one period to another in violation of the principle that reserves should not be used for the purpose of equalizing reported income.

6. It has been argued with respect to inventories that losses which will have to be taken in periods of receding price levels have their origins in periods of rising prices, and that therefore reserves to provide for future price declines should be created in periods of rising prices by charges against the operations of those periods. Reserves of this kind involve assumptions as to what future price levels will be, what inventory quantities will be on hand if and when a major price decline takes place, and finally whether loss to the business will be measured by the amount of the decline in prices. The bases for such assumptions are so uncertain that any conclusions drawn from them would generally seem to be speculative guesses rather than informed judgments. When estimates of this character are included in current costs, amounts representing mere conjecture are combined with others representing reasonable approximations.

7. The committee is therefore of the opinion that reserves such as those created:

(a) for general undetermined contingencies, or

(b) for any indefinite possible future losses, such as, for example, losses on inventories not on hand or contracted for, or

(c) for the purpose of reducing inventories other than to a basis which is in accordance with generally accepted accounting principles,[3] or

(d) without regard to any specific loss reasonably related to the operations of the current period, or

(e) in amounts not determined on the basis of any reasonable estimates of costs or losses

are of such a nature that charges or credits relating to such reserves should not enter into the determination of net income.

8. Accordingly, it is the opinion of the committee that if a reserve of the type described in paragraph 7 is set up:

(a) it should be created by a segregation or appropriation of earned surplus,

(b) no costs or lossees should be charged to it and no part of it should be transferred to income or in any way used to affect the determination of net income for any year,[4]

(c) it should be restored to earned surplus directly when such a reserve or any part thereof is no longer considered necessary,[4] and

(d) it should preferably be classified in the balance sheet as a part of shareholders' equity.

[1] See chapter 2(b); also chapter 8, paragraphs 11, 12, and 13.

[2] See chapter 4.

[3] See particularly chapter 4.

[4] Items (b) and (c) of paragraph 8 also apply to contingency reserves set up in prior years.

CHAPTER 7 Capital Accounts

Section A—Quasi-Reorganization or Corporate Readjustment (Amplification of Institute Rule No. 2 of 1934)

1. A rule was adopted by the Institute in 1934 which read as follows:

"Capital surplus, however created, should not be used to relieve the income account of the current or future years of charges which would otherwise fall to be made thereagainst. This rule might be subject to the exception that where, upon reorganization, a reorganized company would be relieved of charges which would require to be made against income if the existing corporation were continued, it might be regarded as permissible to accomplish the same result without reorganization provided the facts were as fully revealed to and the action as formally approved by the shareholders as in reorganization."[1]

2. Readjustments of the kind mentioned in the exception to the rule fall in the category of what are called quasi-reorganizations. This section does not deal with the general question of quasi-reorganizations, but only with cases in which the exception permitted under the rule of 1934 is availed of by a corporation. Hereinafter such cases are referred to as readjustments. The problems which arise fall into two groups: (a) what may be permitted in a readjustment and (b) what may be permitted thereafter.

PROCEDURE IN READJUSTMENT

3. If a corporation elects to restate its assets, capital stock, and surplus through a readjustment and thus avail itself of permission to relieve its future income account or earned surplus account of charges which would otherwise be made thereagainst, it should make a clear report to its shareholders of the restatements proposed to be made, and obtain their formal consent. It should present a fair balance sheet as at the date of the readjustment, in which the adjustment of carrying amounts is reasonably complete, in order that there may be no continuation of the circumstances which justify charges to capital surplus.

4. A write-down of assets below amounts which are likely to be realized thereafter, though it may result in conservatism in the balance sheet at the readjustment data, may also result in overstatement of earnings or of earned surplus when the assets are subsequently realized. Therefore, in general, assets should be carried forward as of the date of readjustment at fair and not unduly conservative amounts, determined with due regard for the accounting to be employed by the company thereafter. If the fair value of any asset is not readily determinable a conservative estimate may be made, but in that case the amount should be described as an estimate and any material difference arising through realization or otherwise and not attributable to events occurring or circumstances arising after that date should not be carried to income or earned surplus.

5. Similarly, if potential losses or charges are known to have arisen prior to the date of readjustment but the amounts thereof are then indeterminate, provision may properly be made to cover the maximum *probable* losses or charges. If the amounts provided are subsequently found to have been excessive or insufficient, the differences should not be carried to earned surplus nor used to offset losses or gains originating after the readjustment, but should be carried to capital surplus.

6. When the amounts to be written off in a readjustment have been determined, they should be charged first against earned surplus to the full extent of such surplus; any balance may then be charged against capital surplus. A company which has subsidiaries should apply this rule in such a way that no consolidated earned surplus survives a readjustment in which any part of losses has been charged to capital surplus.

7. If the earned surplus of any subsidiaries cannot be applied against the losses before resort is had to capital surplus, the parent company's interest in such earned surplus should be regarded as capitalized by the readjustment just as surplus at the date of acquisition is capitalized, so far as the parent is concerned.

[1] See chapter 1(a), paragraph 2.

8. The effective date of the readjustment, from which the income of the company is thereafter determined, should be as near as practicable to the date on which formal consent of the stockholders is given, and should ordinarily not be prior to the close of the last completed fiscal year.

PROCEDURE AFTER READJUSTMENT

9. When the readjustment has been completed, the company's accounting should be substantially similar to that appropriate for a new company.

10. After such a readjustment earned surplus previously accumulated cannot properly be carried forward under that title. A new earned surplus account should be established, dated to show that it runs from the effective date of the readjustment, and this dating should be disclosed in financial statements until such time as the effective date is no longer deemed to possess any special significance.

11. Capital surplus originating in such a readjustment is restricted in the same manner as that of a new corporation; charges against it should be only those which may properly be made against the initial surplus of a new corporation.

12. It is recognized that charges against capital surplus may take place in other types of readjustments to which the foregoing provisions would have no application. Such cases would include readjustments for the purpose of correcting erroneous credits made to capital surplus in the past. In this statement the committee has dealt only with that type of readjustment in which either the current income or earned surplus account or the income account of future years is relieved of charges which would otherwise be made thereagainst.

Section B—Stock Dividends and Stock Split-Ups

1. The term *stock dividend* as used in this chapter refers to an issuance by a corporation of its own common shares to its common shareholders without consideration and under conditions indicating that such action is prompted mainly by a desire to give the recipient shareholders some ostensibly separate evidence of a part of their respective interests in accumulated corporate earnings without distribution of cash or other property which the board of directors deems necessary or desirable to retain in the business.

2. The term *stock split-up* as used in this chapter refers to an issuance by a corporation of its own common shares to its common shareholders without consideration and under conditions indicating that such action is prompted mainly by a desire to increase the number of outstanding shares for the purpose of effecting a reduction in their unit market price and, thereby, of obtaining wider distribution and improved marketability of the shares.

3. This chapter is not concerned with the accounting for a distribution or issuance to shareholders of (a) shares of another corporation theretofore held as an investment, or (b) shares of a different class, or (c) rights to subscribe for additional shares or (d) shares of the same class in cases where each shareholder is given an election to receive cash or shares.

4. The discussion of accounting for stock dividends and split-ups that follows is divided into two parts. The first deals with the problems of the recipient. The second deals with the problems of the issuer.

AS TO THE RECIPIENT

5. One of the basic problems of accounting is that of income determination. Complete discussion of this problem is obviously beyond the scope of this chapter. Basically, income is a realized gain and in accounting is recognized, recorded, and stated in accordance with certain principles as to time and amount.

6. In applying the principles of income determination to the accounts of a shareholder of a corporation, it is generally agreed that the problem of determining his income is distinct from the problem of income determination by the corporation itself. The income of the corporation is determined as that of a separate entity without regard to the equity of the respective shareholders in such income. Under conventional accounting concepts, the shareholder has no income solely as a result of the fact that the corporation has income; the increase in his equity through undistributed earnings is no more than potential income to him. It is true that income earned by the corporation may result in an enhancement in the market

value of the shares, but until there is a distribution, division, or severance of corporate assets, the shareholder has no income. If there is an increase in the market value of his holdings, such unrealized appreciation is not income. In the case of a stock dividend or split-up, there is no distribution, division, or severance of corporate assets. Moreover, there is nothing resulting therefrom that the shareholder can realize without parting with some of his proportionate interest in the corporation.

7. The foregoing are important points to be considered in any discussion of the accounting procedures to be followed by the recipient of a stock dividend or split-up since many arguments put forward by those who favor recognizing stock dividends as income are in substance arguments for the recognition of corporate income as income to the shareholder as it accrues to the corporation, and prior to its distribution to the shareholder; the acceptance of such arguments would require the abandonment of the *separate entity* concept of corporation accounting.

8. The question as to whether or not stock dividends are income has been extensively debated; the arguments pro and con are well known.[1] The situation cannot be better summarized, however, than in the words approved by Mr. Justice Pitney in *Eisner v. Macomber*, 252 U. S. 189, wherein it was held that stock dividends are not income under the Sixteenth Amendment, as follows:

> "A stock dividend really takes nothing from the property of the corporation and adds nothing to the interests of the stockholders. Its property is not diminished and their interests are not increased . . . the proportional interest of each shareholder remains the same. The only change is in the evidence which represents that interest, the new shares and the original shares together representing the same proportional interests that the original shares represented before the issue of the new ones."

9. Since a shareholder's interest in the corporation remains unchanged by a stock dividend or split-up except as to the number of share units constituting such interest, the cost of the shares previously held should be allocated equitably to the total shares held after receipt of the stock dividend or split-up. When any shares are later disposed of, a gain or loss should be determined on the basis of the adjusted cost per share.

AS TO THE ISSUER

Stock Dividends

10. As has been previously stated, a stock dividend does not, in fact, give rise to any change whatsoever in either the corporation's assets or its respective shareholders' proportionate interests therein. However, it cannot fail to be recognized that, merely as a consequence of the expressed purpose of the transaction and its characterization as a *dividend* in related notices to shareholders and the public at large, many recipients of stock dividends look upon them as distributions of corporate earnings and usually in an amount equivalent to the fair value of the additional shares received. Furthermore, it is to be presumed that such views of recipients are materially strengthened in those instances, which are by far the most numerous, where the issuances are so small in comparison with the shares previously outstanding that they do not have any apparent effect upon the share market price and, consequently, the market value of the shares previously held remains substantially unchanged. The committee therefore believes that where these circumstances exist the corporation should in the public interest account for the transaction by transferring from earned surplus to the category of permanent capitalization (represented by the capital stock and capital surplus accounts) an amount equal to the fair value of the additional shares issued. Unless this is done, the amount of earnings which the shareholder may believe to have been distributed to him will be left, except to the extent otherwise dictated by legal requirements, in earned surplus subject to possible further similar stock issuances or cash distributions.

11. Where the number of additional shares issued as a stock dividend is so great that it has, or may reasonably be expected to have, the effect of materially reducing the share market value, the committee believes that the implications and possible constructions discussed in the preceding paragraph are not likely to exist and that the transaction clearly partakes of the nature of a stock split-up as defined in paragraph 2. Conse-

[1] See, for instance, Freeman, "Stock Dividends and the New York Stock Exchange," *American Economic Review*, December, 1931 (pro), and Whitaker, "Stock Dividends, Investment Trusts, and the Exchange," *American Economic Review*, June, 1931 (con).

quently, the committee considers that under such circumstances there is no need to capitalize earned surplus, other than to the extent occasioned by legal requirements. It recommends, however, that in such instances every effort be made to avoid the use of the word *dividend* in related corporate resolutions, notices, and announcements and that, in those cases where because of legal requirements this cannnot be done, the transaction be described, for example, as a *split-up effected in the form of a dividend.*

12. In cases of closely-held companies, it is to be presumed that the intimate knowledge of the corporations' affairs possessed by their shareholders would preclude any such implications and possible constructions as are referred to in paragraph 10. In such cases, the committee believes that considerations of public policy do not arise and that there is no need to capitalize earned surplus other than to meet legal requirements.

13. Obviously, the point at which the relative size of the additional shares issued becomes large enough to materially influence the unit market price of the stock will vary with individual companies and under differing market conditions and, hence, no single percentage can be laid down as a standard for determining when capitalization of earned surplus in excess of legal requirements is called for and when it is not. However, on the basis of a review of market action in the case of shares of a number of companies having relatively recent stock distributions, it would appear that there would be few instances involving the issuance of additional shares of less than, say, 20% or 25% of the number previously outstanding where the effect would not be such as to call for the procedure referred to in paragraph 10.

14. The corporate accounting recommended in paragraph 10 will in many cases, probably the majority, result in the capitalization of earned surplus in an amount in excess of that called for by the laws of the state of incorporation; such laws generally require the capitalization only of the par value of the shares issued, or, in the case of shares without par value, an amount usually within the discretion of the board of directors. However, these legal requirements are, in effect, minimum requirements and do not prevent the capitalization of a larger amount per share.

Stock Split-Ups

15. Earlier in this chapter a stock split-up was defined as being confined to transactions involving the issuance of shares, without consideration moving to the corporation, for the purpose of effecting a reduction in the unit market price of shares of the class issued and, thus, of obtaining wider distribution and improved marketability of the shares. Where this is clearly the intent, no transfer from earned surplus to capital surplus or capital stock account is called for, other than to the extent occasioned by legal requirements. It is believed, however, that few cases will arise where the aforementioned purpose can be accomplished through an issuance of shares which is less than, say, 20% or 25% of the previously outstanding shares.

16. The committee believes that the corporation's representations to its shareholders as to the nature of the issuance is one of the principal considerations in determining whether it should be recorded as a stock dividend or a split-up. Nevertheless, it believes that the issuance of new shares in ratios of less than, say, 20% or 25% of the previously outstanding shares, or the frequent recurrence of issuances of shares, would destroy the presumption that transactions represented to be split-ups should be recorded as split-ups.

Three members of the committee, Messrs. Knight, Calkins, and Mason, assented with qualification, and one member, Mr. Wilcox, dissented to adoption of section (b) of chapter 7.

Mr. Knight assents with the qualification that he believes the section should recognize the propriety of treating as income stock dividends received by a parent from a subsidiary. He believes the section should have retained from the original Bulletin No. 11 the statement, "It is recognized that this rule, under which the stockholder has no income until there is a distribution, division, or severance, may require modification in some cases, or that there may be exceptions to it, as, for instance, in the case of a parent company with respect to its subsidiaries. . . ."

Messrs. Calkins and Mason approve part one, but believe part two is inconsistent therewith in that the former concludes that a stock dividend is not income to the recipient while the latter suggests accounting procedures by the issuer based on the assumption that the shareholder may think otherwise. They believe it is inappropriate for the corporate entity to base its accounting on considerations of possible shareholder reactions. They also believe that part two deals with matters of corporate policy rather than accounting principles and that the purpose sought to be served could be more effectively accomplished by appropriate notices to shareholders at the time of the issuance of additional shares.

Mr. Wilcox dissents from the recommendations made both as to the recipient and as to the issuer. He believes that, with proper safeguards, stock dividends should be regarded as marking the point at which corporate income is to be recognized by shareholders, and denies that the arguments favoring this view are in substance arguments for the recognition of corporate income as income to the shareholder as it accrues to the corporation. He believes that the arguments regarding severance and maintenance of proportionate interest are unsound, and cannot logically be invoked as they are in this section, since they are widely ignored with respect to distributions of securities other than common stock dividends. Mr. Wilcox believes the recommendations as to the issuer are inconsistent with the rest of the section, involve arbitrary distinctions, hamper or discourage desirable corporate actions, result in meaningless segregation in the proprietorship section of balance sheets, and serve no informative purpose which cannot be better served by explanatory disclosures. He therefore also dissents from the omission of requirements for information and disclosures which were contained in the original Bulletin No. 11 issued in September, 1941.

Section C—Business Combinations

1. Whenever two or more corporations are brought together, or combined, for the purpose of carrying on in a single corporation the previously conducted businesses, the accounting to give effect to the combination will vary depending upon whether there is a continuance of the former ownership or a new ownership.[1] This section (a) differentiates these two types of corporate combinations, the first of which is designated herein as a *pooling of interests* and the second as a *purchase;* and (b) indicates the nature of the accounting treatment appropriate to each type.

2. For accounting purposes, the distinction between a pooling of interests and a purchase is to be found in the attendant circumstances rather than in the legal designation as a merger or a consolidation, or in legal considerations with respect to availability of net assets for dividends, or provisions of the Internal Revenue Code with respect to income taxes. In a pooling of interests, all or substantially all of the equity interests in predecessor corporations continue, as such, in a surviving corporation[1] which may be one of the predecessor corporations, or in a new one created for the purpose. In a purchase, on the other hand, an important part or all of the ownership of the acquired corporation is eliminated. A plan or firm intention and understanding to retire capital stock issued to the owners of one or more of the corporate parties, or substantial changes in ownership occurring immediately before or after the combination, would also tend to indicate that the combination is a purchase.

3. Other factors to be taken into consideration in determining whether a purchase or a pooling of interests is involved are the relative size of the constituent companies and the continuity of management or power to control the management. Thus, a purchase may be indicated when one corporate party to a combination is quite minor in size in relation to the others, or where the management of one of the corporate parties to the combination is eliminated or its influence upon the management of the surviving corporation is very small. Other things being equal, the presumption that a pooling of interests is involved would be strengthened if the activities of the businesses to be combined are either similar or complementary. No one of these factors would necessarily be determinative, but their presence or absence would be cumulative in effect.

4. When a combination is deemed to be a purchase the assets purchased should be recorded on the books of the acquiring company at cost, measured in money or the fair value of other consideration given, or

[1] When the shares of stock in the surviving corporation that are received by the several owners of one of the predecessor companies are not substantially in proportion to their respective interests in the predecessor company, a new ownership or purchase of such company is presumed to result.

at the fair value of the property acquired, whichever is more clearly evident. This is in accordance with the procedure applicable to accounting for purchases of assets.

5. When a combination is deemed to be a pooling of interests, the necessity for a new basis of accountability does not arise. The carrying amounts of the assets of the constituent companies, if stated in conformity with generally accepted accounting principles and appropriately adjusted when deemed necessary to place them on a uniform basis, should be carried forward; and earned surpluses of the constituent companies may be carried forward. However, any adjustment of assets or of surplus which would be in conformity with generally accepted accounting principles in the absence of a combination would be equally so if effected in connection with a pooling of interests. If one party to such a combination had been acquired by purchase as a subsidiary by another such party prior to the origin of a plan of combination, the parent's share of the earned surplus of the subsidiary prior to such acquisition should not be included in the earned surplus account of the pooled companies.

6. Because of the variety of conditions under which a pooling of interests may be carried out it is not practicable to deal with the accounting presentation except in general terms. A number of problems will arise. For example, the stated capital of the surviving corporation in a pooling of interests may be either more than, or less than, the total of the stated capital of the predecessor corporations. In the former event the excess should be deducted first from the total of any other contributed capital (capital surplus), and next from the total of any earned surplus of the predecessors, while in the latter event the difference should appear in the balance sheet of the surviving corporation as other contributed capital (capital surplus), analogous to that created by a reduction in stated capital where no combination is involved.

7. When a combination results in carrying forward the earned surpluses of the constituent companies, statements of operations issued by the continuing business for the period in which the combination occurs and for any preceding period should show the results of operations of the combined interests.

CHAPTER 8 Income and Earned Surplus

1. The purpose of this chapter is to recommend criteria for use in identifying material extraordinary charges and credits which may in some cases and should in other cases be excluded from the determination of net income and to recommend methods of presenting these charges and credits.

2. In dealing with the problem of selecting the most useful form of income statement, the danger of understatement or overstatement of income must be recognized. An important objective of income presentation should be the avoidance of any practice that leads to income equalization.

3. Attention is directed to certain facts which serve to emphasize that the word *income* is used to describe a general concept, not a specific and precise thing, and that the income statement is based on the concept of the *going concern*. It is at best an interim report. Profits are not fundamentally the result of operations during any short period of time. Allocations to fiscal periods of both charges and credits affecting the determination of net income are, in part, estimated and conventional and based on assumptions as to future events which may be invalidated by experience. While the items of which this is true are usually few in relation to the total number of transactions, they sometimes are large in relation to the other amounts in the income statement.

4. It must also be recognized that the ultimate distinction between *operating* income and charges and *non-operating* gains and losses, terms having considerable currency in the accounting profession, has not been established. The former are generally defined as recurrent features of business operation, more or less normal and dependable in their incidence from year to year; the latter are generally considered to be irregular and unpredictable, more or less fortuitous and incidental. The committee is also mindful that the term *net income* has been used indiscriminately and often without precise, and most certainly without uniform, definition in the financial press, investment services, annual reports, prospectuses, contracts relating to compensation of management, bond indentures,

preferred stock dividend provisions, and many other places.

5. In the committee's view, the above facts with respect to the income statement and the income which it displays make it incumbent upon readers of financial statements to exercise great care at all times in drawing conclusions from them.

6. The question of what constitutes the most practically useful concept of income for the year is one on which there is much difference of opinion. On the one hand, net income is defined according to a strict proprietary concept by which it is presumed to be determined by the inclusion of all items affecting the net increase in proprietorship during the period except dividend distributions and capital transactions. The form of presentation which gives effect to this broad concept of net income has sometimes been designated the *all-inclusive* income statement. On the other hand, a different concept places its principal emphasis upon relationship of items to the operations, and to the year, excluding from the determination of net income any material extraordinary items which are not so related or which, if included, would impair the significance of net income so that misleading inferences might be drawn therefrom. This latter concept would require the income statement to be designed on what might be called a *current operating performance* basis, because its chief purpose is to aid those primarily interested in what a company was able to earn under the operating conditions of the period covered by the statement.

7. Proponents of the *all-inclusive* type of income statement insist that annual income statements taken for the life of an enterprise should, when added together, represent total net income. They emphasize the dangers of possible manipulation of the annual earnings figure if material extraordinary items may be omitted in the determination of income. They also assert that, over a period of years, charges resulting from extraordinary events tend to exceed the credits, and the omission of such items has the effect of indicating a greater earning performance than the corporation actually has exhibited. They insist that an income statement which includes all income charges or credits arising during the year is simple to prepare, is easy to understand, and is not subject to variations resulting from the different judgments that may be applied in the treatment of individual items. They argue that when judgment is allowed to enter the picture with respect to the inclusion or exclusion of special items, material differences in the treatment of borderline cases develop and that there is danger that the use of *distortion* as a criterion may be a means of accomplishing the equalization of income. With full disclosure of the nature of any special or extraordinary items, this group believes the user of the financial statements can make his own additions or deductions more effectively than can the management or the independent accountant.

8. Those who favor the *all-inclusive* income statement largely assume that those supporting the *current operating performance* concept are mainly concerned with establishing a figure of net income for the year which will carry an implication as to future earning capacity. Having made this assumption, they contend that income statements should not be prepared on the *current operating performance* basis because income statements of the past are of only limited help in the forecasting of the earning power of an enterprise. This group also argues that items reflecting the results of unusual or extraordinary events are part of the earnings history of the company, and accordingly should be given weight in any effort to make financial judgments with respect to the company. Since a judgment as to the financial affairs of an enterprise should involve a study of the results of a period of prior years, rather than of a single year, this group believes that the omission of material extraordinary items from annual income statements is undesirable since there would be a greater tendency for those items to be overlooked in such a study.

9. On the other hand, those who advocate the *current operating performance* type of income statement generally do so because they are mindful of the particular business significance which a substantial number of the users of financial reports attach to the income statement. They point out that, while some users of financial reports are able to analyze a statement and eliminate from it those unusual and extraordinary items that tend to distort it for their purposes, many users are not trained to do so. Furthermore, they contend, it is difficult at best to report in any financial statement sufficient data to afford a sound basis upon which the reader who does not have an intimate knowledge of the facts can make a well-considered classification. They consider it self-evident that management and the independent auditors are in

a better position than outsiders to determine whether there are unusual and extraordinary items which, if included in the determination of net income, may give rise to misleading inferences as to current operating performance. Relying on the proper exercise of professional judgment, they discount the contention that neither managements nor the independent auditors, because of the absence of objective standards to guide them, have been able to decide consistently which extraordinary charges and credits should be excluded in determining earning performance. They agree it is hazardous to place too great a reliance on the net income as shown in a single annual statement and insist that a realistic presentation of current performance must be taken for what it is and should not be construed as conveying an implication as to future accomplishments. The net income of a single year is only one of scores of factors involved in analyzing the future earnings prospects or potentialities of a business. It is well recognized that future earnings are dependent to a large extent upon such factors as market trends, product developments, political events, labor relationships, and numerous other factors not ascertainable from the financial statements. However, this group insists that the net income for the year should show as clearly as possible what happened in that year under that year's conditions, in order that sound comparisons may be made with prior years and with the performance of other companies.

10. The advocates of this *current operating performance* type of statement join fully with the so-called *all-inclusive* group in asserting that there should be full disclosure of all material charges or credits of an unusual character, including those attributable to a prior year, but they insist that disclosure should be made in such manner as not to distort the figure which represents what the company was able to earn from its usual or typical business operations under the conditions existing during the year. They point out that many companies, in order to give more useful information concerning their earning performance, make a practice of restating the earnings of a number of prior years after adjusting them to reflect the proper allocation of items not related to the years in which they were first reported. They believe that material extraordinary charges or credits may often best be disclosed as direct adjustments of surplus. They point out that a charge or credit in a material amount representing an unusual item not likely to recur, if included in the computation of annual net income, may be so distorting in its results as to lead to unsound judgments with respect to the current earning performance of the company.

11. The committee has indicated elsewhere[1] that in its opinion it is plainly desirable that over the years all profits and losses of a business be reflected in net income, but at the same time has recognized that, under appropriate circumstances, it is proper to exclude certain material charges and credits from the determination of the net income of a single year, even though they clearly affect the cumulative total of income for a series of years. In harmony with this view, **it is the opinion of the committee that there should be a general presumption that all items of profit and loss recognized during the period are to be used in determining the figure reported as net income. The only possible exception to this presumption relates to items which in the aggregate are material in relation to the company's net income and are clearly not identifiable with or do not result from the usual or typical business operations of the period.** Thus, only extraordinary items such as the following may be excluded from the determination of net income for the year, and they should be excluded when their inclusion would impair the significance of net income so that misleading inferences might be drawn therefrom:[2]

(a) Material charges or credits (other than ordinary adjustments of a recurring nature) specifically related to operations of prior years, such as the elimination of unused reserves provided in prior years and adjustments of income taxes for prior years;

(b) Material charges or credits resulting from unusual sales of assets not acquired for resale and not of the type in which the company generally deals;

(c) Material losses of a type not usually insured against, such as those resulting from wars, riots, earthquakes, and similar calamities or catastrophes except where such losses are a recurrent hazard of the business;

[1] See chapter 2(b), paragraph 3.
[2] See chapter 10(b) with respect to the allocation of income taxes.

(d) The write-off of a material amount of intangibles;[3]

(e) The write-off of material amounts of unamortized bond discount or premium and bond issue expenses at the time of the retirement or refunding of the debt before maturity.

12. The following, however, should be excluded from the determination of net income under all circumstances:

(a) Adjustments resulting from transactions in the company's own capital stock;

(b) Amounts transferred to and from accounts properly designated as surplus appropriations, such as charges and credits with respect to general purpose contingency reserves;

(c) Amounts deemed to represent excessive costs of fixed assets, and annual appropriations in contemplation of replacement of productive facilities at higher price levels;[4] and

(d) Adjustments made pursuant to a quasi-reorganization.

13. Consideration has been given to the methods of presentation of the extraordinary items excluded in the determination of net income under the criteria set forth in paragraph 11. One method is to carry all such charges and credits directly to the surplus account with complete disclosure as to their nature and amount. A second method is to show them in the income statement after the amount designated as net income. Where the second method is used, misconceptions are likely to arise as to whether earnings for the period are represented by the amount actually designated as net income or by the final, and often more prominent, amount shown on the income statement after deduction or addition of material extraordinary items excluded from the determination of net income. Having in mind the possibility of such misconceptions where the second method is employed, the committee believes that the first method more clearly portrays net income. It should be noted that the Securities and Exchange Commission, in its revised Regulation S-X issued in December, 1950, made provision in item 17 of Rule 5-03 for the addition to or deduction from net income or loss, at the bottom of income statements filed with the Commission, of items of profit and loss given recognition in the accounts during the period and not included in the determination of net income or loss. The change in Rule 5-03 does not affect the determination of the amount to be reported as net income or earnings for the year. Furthermore, the additions or deductions at the foot of the income statement after determination of net income are equivalent to direct credits or charges to earned surplus. In view of the foregoing, and although the committee strongly prefers the first method, it considers the second method of presentation described above to be acceptable provided care is taken that the figure of net income is clearly and unequivocally designated so as not to be confused with the final figure in the income statement. Thus it is imperative that the caption of the final figure should precisely describe what it represents, e.g., *net income and special items, net income and refund of 1945 excess profits taxes, net loss and special items,* or *profit on sale of subsidiary less net loss.* A company may use the first method of presentation in one statement and the second method in another like statement covering the same fiscal period. The committee wishes to make clear that neither of the above-described methods of presentation precludes the use of the combined statement of income and earned surplus.[5] However, where such combined statement is utilized, the committee's preference is that the figure of net income be followed immediately by the surplus balance at the beginning of the period. It is also the committee's opinion that deduction of the single item of dividends from net income on the income statement would not be subject to misconception.

14. In its deliberations concerning the nature and purpose of the income statement, the committee has been mindful of the disposition of even well-informed persons to attach undue importance to a single net income figure and to *earnings per share* shown for a particular year. The committee directs attention to the undesirability in many cases of the dissemination of information in which major prominence is given to a single figure of *net income* or *net income per share.* However, if such income data are reported (as in newspapers, investors' services, and annual corporate reports), the committee strongly urges that any determination of *income per share* be related to the amount designated in the income statement as net income and that where material extraordinary charges or credits have been

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[3] See chapter 5, paragraphs 8 and 9, for conditions under which a material portion or the entire amount of intangibles described therein as type (b) may be written off.

[4] See chapter 9(a) and dissents thereto.

[5] See chapter 2(b).

excluded from the determination of net income, the corresponding total or per-share amount of such charges and credits also be reported separately and simultaneously. In this connection the committee earnestly solicits the cooperation of all organizations, both governmental and private, engaged in the compilation of business earnings statistics from annual reports.

CHAPTER 9 Depreciation

Section A—Depreciation and High Costs

1. In December, 1947, the committee issued Accounting Research Bulletin No. 33, dealing with the subject of depreciation and high costs. In October, 1948, it published a letter to the membership reaffirming the opinion expressed in the bulletin.

2. The subject is one of continuing importance. The committee once more expresses its approval of the basic conclusions asserted in both publications, but in view of the many requests received for further consideration of various aspects of the problem has placed the subject on its agenda for further study.

3. Accounting Research Bulletin No. 33 read as follows:

4. "The American Institute of Accountants committee on accounting procedure has given extensive consideration to the problem of making adequate provision for the replacement of plant facilities in view of recent sharp increases in the price level. The problem requires consideration of charges against current income for depreciation of facilities acquired at lower price levels.

5. "The committee recognizes that business management has the responsibility of providing for replacement of plant and machinery. It also recognizes that, in reporting profits today, the cost of material and labor is reflected in terms of 'inflated' dollars while the cost of productive facilities in which capital was invested at a lower price level is reflected in terms of dollars whose purchasing power was much greater. There is no doubt that in considering depreciation in connection with product costs, prices, and business policies, management must take into consideration the probability that plant and machinery will have to be replaced at costs much greater than those of the facilities now in use.

6. "When there are gross discrepancies between the cost and current values of productive facilities, the committee believes that it is entirely proper for management to make annual appropriations of net income or surplus in contemplation of replacement of such facilities at higher price levels.

7. "It has been suggested in some quarters that the problem be met by increasing depreciation charges against current income. The committee does not believe that this is a satisfactory solution at this time. It believes that accounting and financial reporting for general use will best serve their purposes by adhering to the generally accepted concept of depreciation on cost, at least until the dollar is stabilized at some level. An attempt to recognize current prices in providing depreciation, to be consistent, would require the serious step of formally recording appraised current values for all properties, and continuous and consistent depreciation charges based on the new values. Without such formal steps, there would be no objective standard by which to judge the propriety of the amounts of depreciation charges against current income, and the significance of recorded amounts of profit might be seriously impaired.

8. "It would not increase the usefulness of reported corporate income figures if some companies charged depreciation on appraised values while others adhered to cost. The committee believes, therefore, that consideration of radical changes in accepted accounting procedure should not be undertaken, at least until a stable price level would make it practicable for business as a whole to make the change at the same time.

9. "The committee disapproves immediate write-downs of plant cost by charges against current income in amounts believed to represent excessive or abnormal costs occasioned by current price levels. However, the committee calls attention to the fact that plants expected to have less than normal useful life can properly be depreciated on a systematic basis related to economic usefulness."

10. The letter of October 14, 1948, was addressed to the members of the Institute and read as follows:

11. "The committee on accounting procedure has reached the conclusion that no basic change in the accounting treatment of depreciation of plant and equipment is practicable or desirable under present conditions to meet the problem created by the decline in the purchasing power of the dollar.

12. "The committee has given intensive study to this problem and has examined and discussed various suggestions which have been made to meet it. It has solicited and considered hundreds of opinions on this subject expressed by businessmen, bankers, economists, labor leaders, and others. While there are differences of opinion, the prevailing sentiment in these groups is against any basic change in present accounting procedures. The committee believes that such a change would confuse readers of financial statements and nullify many of the gains that have been made toward clearer presentation of corporate finances.

13. "Should inflation proceed so far that original dollar costs lose their practical significance, it might become necessary to restate all assets in terms of the depreciated currency, as has been done in some countries. But it does not seem to the committee that such action should be recommended now if financial statements are to have maximum usefulness to the greatest number of users.

14. "The commitee, therefore, reaffirms the opinion it expressed in Accounting Research Bulletin No. 33, December, 1947.

15. "Any basic change in the accounting treatment of depreciation should await further study of the nature and concept of business income.

16. "The immediate problem can and should be met by financial management. The committee recognizes that the common forms of financial statements may permit misunderstanding as to the amount which a corporation has available for distribution in the form of dividends, higher wages, or lower prices for the company's products. When prices have risen appreciably since original investments in plant and facilities were made, a substantial proportion of net income as currently reported must be reinvested in the business in order to maintain assets at the same level of productivity at the end of a year as at the beginning.

17. "Stockholders, employees, and the general public should be informed that a business must be able to retain out of profits amounts sufficient to replace productive facilities at current prices if it is to stay in business. The committee therefore gives its full support to the use of supplementary financial schedules, explanations or footnotes by which management may explain the need for retention of earnings."

Six members of the committee, Messrs. Andrews, Peloubet, Peoples, Smith, Wellington, and Williams, dissented to adoption of section (a) of chapter 9.

The six dissenting members object to the reprinting, in this section, of Bulletin No. 33 of December, 1947, and the reaffirming letter of October 14, 1948. That bulletin was issued to check the extension of certain then-emerging practices and it was successful in that purpose. However, Bulletin No. 33 contains assertions which are not now appropriate and should be eliminated, notably:

(a) "An attempt to recognize current prices in providing depreciation . . . would require the serious step of formally recording appraised current values . . . and consistent depreciation charges based on the new values" (par. 7 of this section).

Those dissenting believe this is not the only method which may be followed—a conclusion also reached by the Study Group on Business Income (see page 61 of its report).[1]

(b) ". . . consideration of radical changes in accepted accounting procedure should not be undertaken, at least until a stable price level would make it practicable for business as a whole to make the change at the same time." (par. 8)

This statement virtually precludes changes in accounting practice in so far as the monetary unit is concerned and is inconsistent with the paragraphs on Accounting and the Corporate System in the introduction to this volume.

(c) The warnings (in paragraphs 5, 6, 16 and 17) to management as to the use of profits.

Such warnings are irrelevant; it is no part of the accountant's function to tell management what it may or may not properly do with income after it has been determined.

[1] Study Group on Business Income, *Changing Concepts of Business Income.* New York: The Macmillan Co., 1952. 160 pp.

Those dissenting believe that acceptable accounting practices should comprehend financial statements to stockholders, employees, and the public designed to reflect those concepts of cost and net income which are recommended in paragraph 5 to management in determining product costs, prices, and business policies. They question whether net income can properly be so designated if appropriations therefrom, as suggested in paragraph 6, are needed to preserve capital invested in plant.

They believe that plant may continue to be carried in the balance sheet at historical cost with deduction for depreciation based thereon. In addition to historical depreciation, a supplementary annual charge to income should be permitted with corresponding credit to an account for property replacements and substitutions, to be classified with the stockholders' equity. This supplementary charge should be in such amount as to make the total charge for depreciation express in current dollars the exhaustion of plant allocable to the period. The supplementary charge would be calculated by use of a generally accepted price index applied to the expenditures in the years when the plant was acquired. The last sentence of paragraph 7 would then be no longer valid; the usefulness of financial statements would be enhanced without sacrifice of presently existing comparability.

Section B—Depreciation on Appreciation

1. Historically, fixed assets have been accounted for on the basis of cost. However, fixed assets in the past have occasionally been written up to appraised values because of rapid rises in price levels, to adjust costs in the case of bargain purchases, etc. In some of these instances companies have continued to compute depreciation on the basis of cost.

2. When appreciation has been entered on the books income should be charged with depreciation[1] computed on the written-up amounts. A company should not at the same time claim larger property valuations in its statement of assets and provide for the amortization of only smaller amounts in its statement of income. When a company has made representations as to an increased valuation of plant, depreciation accounting and periodic income determination thereafter should be based on such higher amounts.

Three members of the committee, Messrs. Calkins, Lindquist, and Mason, assented with qualification to adoption of section (b) of chapter 9.

Messrs. Calkins, Lindquist, and Mason believe that, as a matter of consistency, where increased property valuations have been entered on the books the credit item should be treated as permanent capital and would therefore not be available for subsequent transfer to earned surplus as *realized* through depreciation or sale.

Section C—Emergency Facilities: Depreciation, Amortization and Income Taxes

CERTIFICATES OF NECESSITY

1. Section 124A of the Internal Revenue Code, which was added by the Revenue Act of 1950, provides for the issuance of certificates of necessity under which all or part of the cost of so-called *emergency facilities* may be amortized over a period of 60 months for income-tax purposes. In many cases, the amounts involved are material, and companies are faced with the problem of deciding whether to adopt the 60-month period over which the portions of the cost of the facilities covered by certificates of necessity may be amortized for income-tax purposes as the period over which they are to be depreciated in the accounts.

2. Thinking on this question apparently has become confused because many so-called *percentage certificates* have been issued covering less than the entire cost of the facility. This fact, together with the fact that the probable economic usefulness of the

[1] The word *depreciation* is here used in its ordinary accounting sense and not as the converse of *appreciation*.

facility after the close of the five-year amortization period is considered by the certifying authority in determining the percentage covered by these certificates, has led many to believe that the percentage used represents the government's conclusion as to the proportion of the cost of the facility that is not expected to have usefulness at the end of five years.

3. In some cases, it is apparent that the probable lack of economic usefulness of the facility after the close of the amortization period must constitute the principal if not the sole basis for determining the percentage to be included in the certificate. However, it must be recognized that the certifying authority has acted under orders to give consideration also to a variety of other factors to the end that the amount certified may be the minimum amount necessary to secure expansion of industrial capacity in the interest of national defense during the emergency period. Among the factors required to be considered in the issuance of these certificates, in addition to loss of useful value, are (a) character of business, (b) extent of risk assumed (including the amount and source of capital employed, and the potentiality of recovering capital or retiring debt through tax savings or pricing), (c) assistance to small business and promotion of competition, (d) compliance with government policies (e.g., dispersal for security), and (e) other types of incentives provided by government, such as direct government loans, guaranties, and contractual arrangements.

DEPRECIATION CONSIDERATIONS

4. The argument has been advanced from time to time that, since the portion of the cost of properties covered by certificates of necessity is amortized over a five-year period for income-tax purposes, it is necessary to follow the same procedure in the accounts. Sound financial accounting procedures do not necessarily coincide with the rules as to what shall be included in "gross income," or allowed as a deduction therefrom, in arriving at taxable net income. It is well recognized that such rules should not be followed for financial accounting purposes if they do not conform to generally accepted accounting principles. However, where the results obtained from following income-tax procedures do not materially differ from those obtained where generally accepted accounting principles are followed, there are practical advantages in keeping the accounts in agreement with the income-tax returns.

5. The cost of a productive facility is one of the costs of the services it renders during its useful economic life. Generally accepted accounting principles require that this cost be spread over the expected useful life of the facility in such a way as to allocate it as equitably as possible to the periods during which services are obtained from the use of the facility. This procedure is known as depreciation accounting, a system of accounting which aims to distribute the cost or other basic value of tangible capital assets, less salvage (if any), over the estimated useful life of the unit (which may be a group of assets) in a systematic and rational manner. It is a process of allocation, not of valuation.

6. The committee is of the opinion that from an accounting standpoint there is nothing inherent in the nature of emergency facilities which requires the depreciation or amortization of their cost for financial accounting purposes over either a shorter or a longer period than would be proper if no certificate of necessity had been issued. Estimates of the probable useful life of a facility by those best informed in the matter may indicate either a shorter or a longer life than the statutory 60-month period over which the certified portion of its cost is deductible for income-tax purposes.

7. In determining the proper amount of annual depreciation with respect to emergency facilities for financial accounting purposes, it must be recognized that a great many of these facilities are being acquired primarily for what they can produce during the emergency period. To whatever extent it is reasonable to expect the useful economic life of a facility to end with the close of the amortization period the cost of the facility is a proper cost of operation during that period.

8. In determining the prospective usefulness of such facilities it will be necessary to consider their adaptability to post-emergency use, the effect of their use upon economic utilization of other facilities, the possibility of excessive costs due to expedited construction or emergency conditions, and the fact that no deductions for depreciation of the certified portion will be allowable for income-tax purposes in the post-amortization years if the company elects to claim the amortization deduction. The purposes for which emergency facilities are acquired

in a great many cases are such as to leave major uncertainties as to the extent of their use during the amortization period and as to their subsequent usefulness—uncertainties which are not normally encountered in the acquisition and use of operating facilities.

9. Consideration of these factors, the committee believes, will in many cases result in the determination of depreciation charges during the amortization period in excess of the depreciation that would be appropriate if these factors were not involved. Frequently they will be so compelling as to indicate the need for recording depreciation of the cost of emergency facilities in the accounts in conformity with the amortization deductions allowable for income-tax purposes. However, the committee believes that when the amount allowed as amortization for income-tax purposes is materially different from the amount of the estimated depreciation, the latter should be used for financial accounting purposes.

10. In some cases, certificates of necessity cover facilities which the owner expects to use after the emergency period in lieu of older facilities. As a result the older facilities may become unproductive and obsolete before they are fully depreciated on the basis of their previously expected life. In such situations, the committee believes depreciation charges to income should be determined in relation to the total properties, to the end that sound depreciation accounting may be applied to the property accounts as a whole.

RECOGNITION OF INCOME TAX EFFECTS

11. In those cases in which the amount of depreciation charged in the accounts on that portion of the cost of the facilities for which certificates of necessity have been obtained is materially less than the amount of amortization deducted for income-tax purposes, the amount of income taxes payable annually during the amortization period may be significantly less than it would be on the basis of the income reflected in the financial statements. In such cases, after the close of the amortization period the income taxes will exceed the amount that would be appropriate on the basis of the income reported in the statements. Accordingly, the committee believes that during the amortization period, where this difference is material, a charge should be made in the income statement to recognize the income tax to be paid in the future on the amount by which amortization for income-tax purposes exceeds the depreciation that would be allowable if certificates of necessity had not been issued. The amount of the charge should be equal to the estimated amount by which the income tax expected to be payable after the amortization period exceeds what would be so expected if amortization had not been claimed for income-tax purposes in the amortization period. The estimated amount should be based upon normal and surtax rates in effect during the period covered by the income statement with such changes therein as can be reasonably anticipated at the time the estimate is made.

12. In accounting for this deferment of income taxes, the committee believes it desirable to treat the charge as being for additional income taxes. The related credit in such cases would properly be made to an account for deferred income taxes. Under this method, during the life of the facility following the amortization period the annual charges for income taxes will be reduced by charging to the account for deferred income taxes that part of the income tax in excess of what would have been payable had the amortization deduction not been claimed for income-tax purposes in the amortization period. By this procedure the net income will more nearly reflect the results of a proper matching of costs and revenues.

13. There are those who similarly recognize the necessity for giving effect to the amount of the deferred income taxes but who believe this should be accomplished by making a charge in the income account for additional amortization or depreciation. They would carry the related credit to an accumulated amortization or depreciation account as a practical means of recognizing the loss of future deductibility of the cost of the facility for income-tax purposes. If this procedure is followed the annual charges for depreciation will be correspondingly reduced throughout the useful life of the facility following the amortization period. Although this procedure will result in the same amount of net income as the procedure outlined in paragraph 12, and therefore may be considered as acceptable, the committee regards the paragraph 12 procedure as preferable. In any circumstances, there should be disclosure of the procedures followed.

CHAPTER 10 Taxes

Section A—Real and Personal Property Taxes

1. The purpose of this section is to draw attention to the problems involved in accounting for real and personal property taxes and to present some of the considerations which enter into a determination of their accounting treatment.

LEGAL LIABILITY FOR PROPERTY TAXES AND TREATMENT FOR INCOME-TAX PURPOSES

2. Unlike excise, income, and social security taxes, which are directly related to particular business events, real and personal property taxes are based upon the assessed valuation of property (tangible and intangible) as of a given date, as determined by the laws of a state or other taxing authority. For this reason the legal liability for such taxes is generally considered as accruing at the moment of occurrence of some specific event, rather than over a period of time. Whether such legal accrual should determine the accounting treatment is a question to be discussed later. Tax laws, opinions of attorneys, income-tax regulations, and court decisions have mentioned various dates on which certain property taxes are said to accrue legally. Among them are the following:

(a) Assessment date,

(b) Beginning of taxing authority's fiscal year,

(c) End of taxing authority's fiscal year,

(d) Date on which tax becomes a lien on the property,

(e) Date tax is levied,

(f) Date or dates tax is payable,

(g) Date tax becomes delinquent,

(h) Tax period appearing on tax bill.

3. Most of the foregoing dates are mentioned in tax laws. In a given case several of these dates may coincide.

4. The date to be applied in a particular case necessarily requires reference to the law and court decisions of the state concerned. Where the matter has been litigated, it has often been held that property taxes become a liability at the point of time when they become a lien. The general rule, however, is that such taxes accrue as of the date on which they are assessed. The position of the Bureau of Internal Revenue is that generally property taxes accrue on the assessment date, even if the amount of the tax is not determined until later.

5. A practical aspect of the legal liability for property taxes must be considered when title to property is transferred during the taxable year. As stated above, the assessment date generally determines accrual. But as between vendor and vendee, the Supreme Court[1] has laid down the rule that the lien date, or the date of personal obligation, controls and that where a transfer occurs after either of those dates, the purchaser is not entitled to deduct the taxes for income-tax purposes.

6. Adjustments on account of property taxes paid or accrued are frequently incorporated in agreements covering the sale of real estate, which determine the question for the individual case as between the buyer and seller, though they are not necessarily controlling for income-tax purposes.

7. Although pro-rata accrual of property taxes has been permitted by some courts, the generally accepted rule seems to be that such taxes accrue in a lump sum on one date and not ratably over the year.

ACCOUNTING FOR PROPERTY TAXES

Accrual Accounting

8. Accounting questions arise as to (1) when the liability for real and personal property taxes should be recorded on the books of a taxpayer keeping his accounts on the accrual basis and (2) the amounts to be charged against the income of respective periods. Here again, the decision is influenced by the particular circumstances of each tax. Such terms as *assessment date* and *levy date* vary in meaning in the different jurisdictions; and while there is sufficient agreement about assessment date to furnish a basis for the general legal rule already mentioned, it does not necessarily follow that the legal rule should determine the accounting treatment.

[1] *Magruder v. Supplee,* 316 U. S. 394 (1942).

9. Determination of the liability for the tax often proceeds by degrees, the several steps being taken at appreciable intervals of time. For example, while it is known that the owner of real property is liable, with respect to each tax period, for a tax on property owned on the assessment date, the amount of the tax may not be fixed until much later. There is sometimes reluctance toward recording liabilities of indeterminate amount, especially such items as property taxes, and a preference for recording them when the amount can be computed with certainty. While this consideration is one which occasionally leads to the mention of taxes in footnotes as contingent liabilities, the inability to determine the exact amount of taxes is in itself no justification for failure to recognize an existing tax liability.

10. In practice, real and personal property taxes have been charged against the income of various periods, as indicated below:

(a) Year in which paid (cash basis),

(b) Year ending on assessment (or lien) date,

(c) Year beginning on assessment (or lien) date,

(d) Calendar or fiscal year of taxpayer prior to assessment (or lien) date,

(e) Calendar or fiscal year of taxpayer including assessment (or lien) date,

(f) Calendar or fiscal year of taxpayer prior to payment date,

(g) Fiscal year of governing body levying the tax,

(h) Year appearing on tax bill.

11. Some of these periods may coincide, as when the fiscal year of the taxing body and that of the taxpayer are the same. The charge to income is sometimes made in full at one time, sometimes ratably on a monthly basis, sometimes on the basis of prior estimates, adjusted during or after the period.

12. The various periods mentioned represent varying degrees of conservatism in accrual accounting. Some justification may be found for each usage, but all the circumstances relating to a particular tax must be considered before a satisfactory conclusion is reached.

13. Consistency of application from year to year is the important consideration and selection of any of the periods mentioned is a matter for individual judgment.

Basis Considered Most Acceptable

14. Generally, the most acceptable basis of providing for property taxes is monthly accrual on the taxpayer's books during the fiscal period of the taxing authority for which the taxes are levied. The books will then show, at any closing date, the appropriate accrual or prepayment.

15. It may be argued that the entire amount of tax should logically be accrued by the lien date. Advocates of this procedure vary from those who would accrue the tax by charges to income during the year ending on the lien date, to those who urge setting up the full tax liability on the lien date and charging the amount thereof to income during the subsequent year. However, the basis described in the preceding paragraph is held by the majority of accountants to be practical and satisfactory so long as it is consistently followed.

TREATMENT IN FINANCIAL STATEMENTS

Balance Sheet

16. An accrued liability for real and personal property taxes, whether estimated or definitely known, should be included among the current liabilities. Where estimates are subject to a substantial measure of uncertainty the liability should be described as estimated.

Income Statement

17. While it is sometimes proper to capitalize in property accounts the amount of real estate taxes applicable to property which is being developed for use or sale, these taxes are generally regarded as an expense of doing business. They may be (a) charged to operating expenses; (b) shown as a separate deduction from income; or (c) distributed among the several accounts to which they are deemed to apply, such as factory overhead, rent income, and selling or general expenses.

18. In condensed income statements appearing in published reports, the amounts of real and personal property taxes, however charged in the accounts, are rarely shown separately. They are frequently combined with other taxes but not with taxes on income.

19. Since the liability for property taxes must frequently be estimated at the balance-sheet date, it is often necessary to adjust the provision for taxes of a prior year when their amount has been ascertained. These adjustments should ordinarily be made through

the income statement, either in combination with the current year's provision or as a separate item in the income statement. Such adjustments should not be made in the surplus account, except under the conditions set forth in chapter 8, paragraphs 11, 12, and 13.

One member of the committee, Mr. Wellington, assented with qualification to adoption of section (a) of chapter 10.

Mr. Wellington objects to the statement in paragraph 15 that the basis described in paragraph 14 is held by the majority of accountants to be practical and satisfactory so long as it is consistently followed. In his opinion, the most logical practice is to accrue the entire amount of tax at the lien date, with a corresponding charge to an account such as *taxes unexpired* which will then be reduced pro rata, as outlined in the latter part of the second sentence of paragraph 15.

Section B—Income Taxes

1. This section deals with a number of accounting problems which arise in the reporting of income and excess-profits taxes (hereinafter referred to as *income taxes*) in financial statements. The problems arise largely where (a) material items entering into the computation of taxable income are not included in the income statement and where (b) material items included in the income statement do not enter into the computation of taxable income. The section does not apply where there is a presumption that particular differences between the tax return and the income statement will recur regularly over a comparatively long period of time.

2. Basic difficulties arise in connection with the accounting for income taxes where there are material and extraordinary differences between the taxable income upon which they are computed and the income for the period determined in accordance with generally accepted accounting principles. For example, provisions may be made in the income statement for possible losses not yet realized but requiring recognition under generally accepted accounting principles, such losses, however, being deductible for tax purposes only when they occur. On the other hand, deductions may be taken in the tax return which are not included in the income statement, such as charges against an estimated liability account created in a prior period. Likewise, gains subject to income tax may not be included in the income statement, as for instance, a gain on the sale of property credited to surplus. Also, credits in the income statement may not be includible in taxable income, as when an unneeded past provision for an estimated liability is restored to income.

3. In some cases the transactions result in gains; in others they result in losses or net costs. If all the effects of the transactions (including their effect on income tax) were reflected in the income statement the income would, of course, be increased where the transactions result in a gain and reduced where they result in a loss or net cost. But where the effects are not all reflected in the income statement, and that statement indicates only the income tax actually payable, exactly the opposite effect is produced—where the special transactions result in a gain the net income is reduced; and where they result in a loss, or net cost, the net income is increased. Such results ordinarily detract from the significance or usefulness of the financial statements.

4. Financial statements are based on allocations of receipts, payments, accruals, and various other items. Many of the allocations are necessarily based on assumptions, but no one suggests that allocations based on imperfect criteria should be abandoned in respect of expenses other than income taxes, or even that the method of allocation should always be indicated. Income taxes are an expense that should be allocated, as other expenses are allocated. What the income statement should reflect under this head, as under any other head, is the expense properly allocable to the income included in the income statement for the year.

5. In cases in which transactions included in the surplus statement but not in the income statement increase the income tax payable by an amount that is substantial and is determinable without difficulty, as in the case of a gain credited to surplus, an allocation of income tax between the two statements would ordinarily be made. Objection to allocation in other cases, as where a loss is charged to surplus, has been made on the ground that the amount shown for income taxes in the income statement would be increased beyond the amount of the tax esti-

mated to be actually payable. Further objection has been made on the ground that the amount attributable to accounts other than income is not reasonably determinable.

6. The committee sees no objection to an allocation which results in the division of a given item into two parts one of which is larger than the item itself and is offset by the smaller. The argument that the effect of the special transactions on the amount of tax is not identifiable is usually without substantial merit. The difficulties encountered in allocation of the tax are not greater than those met with in many other allocations of expenses. The allocation procedure recommended here does not, of course, contemplate a determination of the tax effect attributable to every separate transaction. In the committee's view, all that is necessary in making an allocation is to consider the effect on taxes of those special transactions which are not included in the income statement.

7. The cases that are likely to call for allocation are those which transactions affecting the income tax in a manner which would have a distorting effect on net income are included in (a) surplus accounts, (b) deferred-charge accounts, or (c) estimated liability and similar accounts. Methods of applying the allocation principle in these instances are set forth below.

METHODS OF APPLYING THE ALLOCATION PRINCIPLE

Computation of Tax Effect

8. In most cases, it is appropriate to consider the tax effect as the difference between the tax payable with and without including the item in the amount of taxable income. In certain cases the tax effect attributable to a particular transaction for the purposes indicated above may be computed directly as in the case of transactions subject to the capital gains tax. There may also be cases in which it will be appropriate to use a current over-all effective rate or, as in the case of deferred income, an estimated future tax rate. The estimated rate should be based upon normal and surtax rates in effect during the period covered by the income statement with such changes therein as can be reasonably anticipated at the time the estimate is made.

Credits to Surplus

9. Where an item resulting in a material increase in income taxes is credited to surplus, the portion of the provision for income taxes which is attributable to such item should, under the principle of allocation, be charged thereto. The committee suggests, however, that the provision for income taxes estimated as due be shown in the income statement in full and that the portion thereof charged to surplus be shown on the income statement either (a) as a separate deduction from the actual tax or (b) as a separate credit, clearly described.

Charges to Surplus

10. Where an item resulting in a material reduction in income taxes is charged to surplus, the principle of allocation may be applied in the income statement in either of two ways: (a) the provision for income taxes may be shown as if the item in question were not deductible (the total amount of tax estimated to be due for the year being indicated) or (b) a special charge representing the portion of such item equal to the tax reduction resulting therefrom may be separately shown. In either case the amount charged to surplus is reduced accordingly.

Deferred-Charge and Estimated Liability Accounts

11. The principle of allocation applies also where an item resulting in a material reduction in income taxes is charged to or carried forward in a deferred-charge account or charged to an estimated liability account.

12. The deduction for tax purposes in a given year of an item which is carried to or remains in a deferred-charge account will involve a series of charges in future income statements for amortization of the deferred charge, and these charges will not be deductible for tax purposes. In the period in which the item is taken as a deduction for tax purposes a charge should be made in the income statement of an amount equal to the tax reduction, in the manner set forth above with respect to charges to surplus, with a corresponding credit in the deferred-charge account. Thereafter amortization of the deferred charge should be based on the amount as adjusted by such tax reduction.

13. Where an item resulting in a material reduction in income taxes is charged to an estimated liability account the principle of allocation may be applied in the income statement in any of three ways: (a) the current provision for income taxes may be

shown as if the item in question were not deductible (the total amount of tax estimated to be due for the year being indicated), or (b) a charge may be included for a portion of such item equal to the tax reduction resulting therefrom, or (c) the item in question may be charged in the income statement and a credit made in the income statement representing a portion of the estimated liability account equal to the excess of such item over the related tax reduction.

Special Treatment

14. Where the treatments recommended above are considered to be not practicable, the amount of taxes estimated to be actually payable for the year may be shown in the income statement, provided that the pertinent facts, including the amount of the increase or decrease attributable to other accounts, are clearly disclosed either in a footnote or in the body of the income statement.

ADDITIONAL TAXES AND REFUNDS

15. Adjustments of provisions for income taxes of prior periods, as well as any refunds and any assessments of additional amounts, should be included in the income statement unless they are so material as to have a distorting effect on net income;[1] in such event they may be charged or credited to surplus with indication as to the period to which they relate.

CARRY-BACK OF LOSSES AND UNUSED EXCESS-PROFITS CREDITS

16. While claims for refund of income taxes ordinarily should not be included in the accounts prior to approval by the taxing authorities, a claim based on the carry-back provisions of the Internal Revenue Code presumably has as definite a basis as has the computation of income taxes for the year. Therefore, amounts of income taxes paid in prior years which are refundable to the taxpayer as the result of the carry-back of losses or unused excess-profits credits ordinarily should be included in the income statement of the year in which the loss occurs or the unused excess-profits credit arises. Either of two treatments is acceptable: (a) the amount of taxes estimated to be actually payable for such year may be shown in the income statement, with the amount of the tax reduction attributable to the amounts carried back indicated either in a footnote or parenthetically in the body of the income statement; or (b) the income statement may indicate the results of operations without inclusion of such reduction, which reduction should be shown as a final item before the amount of net income for the period.

CARRY-FORWARD OF LOSSES AND UNUSED EXCESS-PROFITS CREDITS

17. Where taxpayers are permitted to carry forward losses or unused excess-profits credits, the committee believes that, as a practical matter, in the preparation of annual income statements the resulting tax reduction should be reflected in the year to which such losses or unused credits are carried. Either of two treatments is acceptable: (a) the amount of taxes estimated to be actually payable for such year may be shown in the income statement, with the amount of the tax reduction attributable to the amounts carried forward indicated either in a footnote or parenthetically in the body of the income statement; or (b) the income statement may indicate the results of operations without inclusion of such reduction, which reduction should be shown as a final item before the amount of net income for the period. However, where it is believed that misleading inferences would be drawn from such inclusion, the tax reduction should be credited to surplus.

DISCLOSURE OF CERTAIN DIFFERENCES BETWEEN TAXABLE AND ORDINARY INCOME

18. If, because of differences between accounting for tax and accounting for financial purposes, no income tax has been paid or provided as to certain significant amounts credited to surplus or to income, disclosure should be made. However, if a tax is likely to be paid thereon, provision should be made on the basis of an estimate of the amount of such tax. This rule applies, for instance, to profits on instalment sales or long-term

[1] See chapter 8, paragraphs 11, 12, and 13.

contracts which are deferred for tax purposes, and to cases where unrealized appreciation of securities is taken into the accounts by certain types of investment companies.

Two members of the committee, Messrs. Wellington and Werntz, assented with qualification to adoption of section (b) of chapter 10.

Mr. Wellington objects to paragraph 17, as he believes that the amount of the reduction in tax of the later year is due to the operations of the prior year, is in effect an adjustment of the net income or net loss previously reported, and, unless it is relatively not significant, should not be included in the income of the current year but should be credited to surplus. In an income statement for several years, he would show this credit to surplus as an addition to the income previously reported for the prior year, with suitable explanation.

Mr. Werntz does not agree with some of the reasoning, particularly paragraph 6, and certain of the conclusions contained in this section. While he believes that in many cases a difference in treatment of items for tax and financial purposes preferably requires a specialized charge or credit in the income account, so that neither a double benefit nor a double deduction results, he believes that the charge or credit may not always be mandatory and should ordinarily be described in terms of the item involved rather than as *taxes*.

CHAPTER 11 Government Contracts

Section A—Cost-Plus-Fixed-Fee Contracts

1. This section deals with accounting problems arising under cost-plus-fixed-fee contracts, hereinafter referred to as CPFF contracts.

SUMMARY STATEMENT

2. Fees under CPFF contracts may be credited to income on the basis of such measurement of partial performance as will reflect reasonably assured realization. One generally acceptable basis is delivery of completed articles. The fees may also be accrued as they are billable, under the terms of the agreements, unless such accrual is not reasonably related to the proportionate performance of the total work or services to be performed by the contractor from inception to completion.

3. Where CPFF contracts involve the manufacture and delivery of products, the reimbursable costs and fees are ordinarily included in appropriate sales or other revenue accounts. Where such contracts involve only services, or services and the supplemental erection of facilities, only the fees should ordinarily be included in revenues.

4. Unbilled costs and fees under such contracts are ordinarily receivables rather than advances or inventory, but should preferably be shown separately from billed accounts receivable.

5. Offsetting of government advances on CPFF contracts by, or against, amounts due from the government on such contracts is acceptable only to the extent that the advances may under the terms of the agreement be offset in settlement, and only if that is the treatment anticipated in the normal course of business transactions under the contract. In case of offset, the amounts offset should be adequately disclosed.

DISCUSSION

6. Contracts in the CPFF form are used (a) for the manufacture and delivery of various products, (b) for the construction of plants and other facilities, and (c) for management and other services. Under these agreements contractors are reimbursed at intervals for their expenditures and in addition are paid a specified fixed fee. Payments on account of the fees (less 10% or other amount which is withheld until completion) are made from time to time as specified in the agreements, usually subject to the approval of the contracting officer. In most cases the amount of each payment is, as a practical matter, determined by the ratio of expenditures made to

the total estimated expenditures rather than on the basis of deliveries or on the percentage of completion otherwise determined.

7. The agreements provide that title to all material applicable thereto vests in the government as soon as the contractor is reimbursed for his expenditures or, in some cases, immediately upon its receipt by the contractor at his plant even though not yet paid for. The contractor has a custodianship responsibility for these materials, but the government usually has property accountability officers at the plant to safeguard government interests.

8. The contracts are subject to cancellation and termination by the government, in which event the contractor is entitled to reimbursement for all expenditures made and an equitable portion of the fixed fee.

9. The government frequently makes advances of cash as a revolving fund or against the final payment due under the agreement.

Major Accounting Problems

10. There are a number of basic accounting problems common to all CPFF contracts. This section deals with the four most important, which are:

(a) When should fees under such contracts be included in the contractor's income statement?

(b) What amounts are to be included in sales or revenue accounts?

(c) What is the proper balance-sheet classification of unbilled costs and fees?

(d) What is the proper balance-sheet treatment of various items, debit and credit, identified with CPFF contracts?

(a) When should fees under such contracts be included in the contractor's income statement?

11. It is recognized that income should be recorded and stated in accordance with certain accounting principles as to time and amount; that profit is deemed to be realized when a sale in the ordinary course of business is effected unless the circumstances are such that collection of the sales price is not reasonably assured; and that delivery of goods sold under contract is normally regarded as the test of realization of profit or loss.

12. In the case of manufacturing, construction, or service contracts, profits are not ordinarily recognized until the right to full payment has become unconditional, i.e., when the product has been delivered and accepted, when the facilities are completed and accepted, or when the services have been fully and satisfactorily rendered. This accounting procedure has stood the test of experience and should not be departed from except for cogent reasons.

13. It is, however, a generally accepted accounting procedure to accrue revenues under certain types of contracts and thereby recognize profits, on the basis of partial performance, where the circumstances are such that total profit can be estimated with reasonable accuracy and ultimate realization is reasonably assured. Particularly where the performance of a contract requires a substantial period of time from inception to completion, there is ample precedent for pro rata recognition of profit as the work progresses, if the total profit and the ratio of the performance to date to the complete performance can be computed reasonably and collection is reasonably assured. Depending upon the circumstances, such partial performance may be established by deliveries, expenditures, or percentage of completion otherwise determined. This rule is frequently applied to long-term construction and other similar contracts; it is also applied in the case of contracts involving deliveries in instalments or the performance of services. However, the rule should be dealt with cautiously and not applied in the case of partial deliveries and uncompleted contracts where the information available does not clearly indicate that a partial profit has been realized after making provision for possible losses and contingencies.

14. CPFF contracts are much like the type of contracts upon which profit has heretofore been recognized on partial performance, and accordingly have at least as much justification for accrual of fee before final delivery as those cited. The risk of loss is practically negligible, the total profit is fairly definite, and even on cancellation, pro rata profit is still reasonably assured.

15. The basic problem in dealing with CPFF contracts is the measure of partial performance, i.e., whether fees thereunder should be accrued under the established rules as to partial deliveries or percentage of completion otherwise determined, or whether, in view of their peculiar terms with respect to part payments, the determination of amounts billable by continuous government audit, and the minimum of risk carried by the contractor, the fees should be accrued as they are billable.

16. Ordinarily it is acceptable to accrue the fees as they become billable. The outstanding characteristic of CPFF contracts is reimbursement for all allowable costs, plus payment of a fixed fee for the contractor's efforts. Delivery of the finished product may not have its usual legal significance because title passes to the government prior thereto and the contractor's right to partial payment becomes unconditional in advance thereof; deliveries are not necessarily, under the terms of the agreement, evidence of the progress of the work or of the contractor's performance. Amounts billable indicate reasonably assured realization, possibly subject to renegotiation, because of the absence of a credit problem and minimum risk of loss involved. The fee appears to be earned when allowable costs are incurred or paid and the fee is billable. Finally, accrual on the basis of amounts billable is ordinarily not a departure from existing rules of accrual on the basis of partial performance, but rather a distinctive application of the rule for determining percentage of completion.

17. Judgment must be exercised in each case as to whether accrual of the fee when billable is preferable to accrual on the usual basis of delivery or of percentage of completion otherwise determined. While the approval of the government as to amounts billable would ordinarily be regarded as objective evidence, factors may exist which suggest an earlier or later accrual. Such factors include indications of substantial difference between estimated and final cost, as where preparatory or tooling-up costs were much more than estimated, raw material needs were greatly and unduly anticipated by advance purchases, or delays in delivery schedules or other circumstances suggest that costs are exceeding estimates. While such factors are normally considered by the government and billings for fees may be temporarily adjusted to safeguard against too early proportionate payment, the contractor, in accruing income, should also consider them, particularly when any substantial lag exists between expenditures and billings and audit thereof. In such cases, the presumption may be that the fee will not be found to be billable when the charges are presented, and conservatism in accrual will be necessary. Excess costs may be indicated in some cases to such an extent that accrual of fee before actual production would be unwise. Where such a situation exists the usual rule of deliveries or percentage of completion may be a preferable method of accruing the fee.

18. There are further questions as to whether the fee may be accrued as it is billed rather than as it becomes billable and whether accrual should be on the basis of the full fee or the full fee less the amount withheld. As to the first question, it seems obvious that when accrual in relation to expenditures is otherwise suitable it should be on the basis of amounts billable, since such matters as clerical delays in assembling data for billing should not affect the income statement. As to the second question, accrual on the basis of 100% of the fee is ordinarily preferable since, while payment of the balance depends on complete performance, such completion is to be expected under ordinary circumstances. Care must be exercised, of course, to provide for possible non-realization where there is doubt as to the collection of claimed costs or of the fee thereon.

(b) What amounts are to be included in sales or revenue accounts?

19. This problem is whether sales or revenue as reported in the income statement should include reimbursable costs and the fee, or the fee alone. The answer to this question depends upon the terms of the contract and upon judgment as to which method gives the more useful information.

20. Some CPFF contracts are service contracts under which the contractor acts solely in an agency capacity, whether in the erection of facilities or the management of operations. These appear to call for inclusion in the income statement of the fee alone. In the case of supply contracts, however, the contractor is more than an agent. For instance, he is responsible to creditors for materials and services purchased; he is responsible to employees for salaries and wages; he ordinarily uses his own facilities in carrying out his agreement; his position in many respects is that of an ordinary principal. In view of these facts, and the desirability of indicating the volume of his activities, it appears desirable to include reimbursable costs, as well as fees, in sales or revenues.

(c) What is the proper balance-sheet classification of unbilled costs and fee?

21. The principal reason for the existence of unbilled costs at any date is the time usually required, after receipt of material or expenditures for labor, etc., to assemble data for billing. The right to bill usually exists upon expenditure or accrual, and that right unquestionably represents a receivable rather than an advance or inventory. There is nevertheless a difference in character

between billed items and unbilled costs and distinction should be made between them on the balance sheet.

(d) What is the proper balance-sheet treatment of various items, debit and credit, identified with CPFF contracts?

22. In statements of current assets and current liabilities, amounts due to and from the same person are ordinarily offset where, under the law, they may be offset in the process of collection or payment. An advance received on a contract is, however, usually not offset unless it is definitely regarded as a payment on account of contract work in progress, in which event it will be shown as a deduction from the related asset. An advance on a CPFF contract usually is made for the purpose of providing a revolving fund and is not ordinarily applied as a partial payment until the contract is completed or nears completion. It therefore appears to be preferable to offset advances on CPFF contracts against receivables in connection with the contracts only when it is expected that the advances will be applied in payment of those particular charges. In any case, amounts offset should be clearly disclosed.

Section B—Renegotiation

1. This section[1] deals with certain aspects of the accounting for those government contracts and subcontracts which are subject to renegotiation.

2. Where such contracts constitute a substantial part of the business done, the uncertainties resulting from the possibilities of renegotiation are usually such that appropriate indication of their existence should be given in the financial statements.

3. It is impossible to lay down general rules which can be applied satisfactorily in all cases. Here, as elsewhere in accounting, there must be an exercise of judgment which should be based on experience and on a clear understanding of the objective to be attained. That objective is to present the fairest possible financial statements, and at the same time make clear any uncertainties that limit the significance of such statements.

4. In keeping with the established accounting principle that provision should be made in financial statements for all liabilities, including reasonable estimates for liabilities not accurately determinable, provision should be made for probable renegotiation refunds wherever the amount of such refunds can be reasonably estimated. Thus, in cases where experience of the company or of comparable companies with renegotiation determinations is available and would make a reasonable estimate practicable, provision in the income account for an estimated refund affecting the current year's operations is called for. In cases in which a reasonable estimate cannot be made, as where the effect of a new or amended renegotiation act cannot be foretold within reasonable limits or where a company is facing renegotiation for the first time and no reliable precedent is available, disclosure of the inability, because of these circumstances, to determine renegotiation effects and of the consequent uncertainties in the financial statements is necessary.

5. In addition to any provision made in the accounts, disclosure by footnote or otherwise may be required as to the uncertainties, their significance, and the basis used in determining the amount of the provision, such as the prior years' experience of the contractor or of similar contractors if their experience is available and is used, renegotiation discussions relating to the current year, etc. Such disclosure may be helpful in informing shareholders or other interested persons as to the company's status under the renegotiation law. It should also be recognized that, if conditions change, the results of a prior-year determination or settlement are not, in most cases, indicative of the amount probably refundable for the current year.

TREATMENT IN FINANCIAL STATEMENTS

6. Provisions made for renegotiation refunds should be included in the balance sheet among the current liabilities.

7. Accounting treatment in the income statement should conform to the concept that profit is deemed to be realized when a sale in the ordinary course of business is effected, unless the circumstances are such that collection of the sales price is not reasonably assured.[2] Renegotiation re-

[1] The comments in this section are considered to be applicable also to price redetermination estimated to result in retroactive price reduction.

[2] See chapter 1, rule 1.

funds are commonly referred to as involving a refund of "excessive profits"; realistically, however, renegotiation involves an adjustment of the original contract or selling price. Since a provision for renegotiation refund indicates that the collection, or retention, of the selling price is not reasonably assured, the provision should preferably be treated in the income statement as a deduction from sales. Because of the interrelationship of renegotiation and taxes on income, the provision for such taxes should then be computed accordingly.

8. The amount refundable is, however, generally a net amount, i.e., allowance is made for any taxes on income which may have been paid or assessed thereon. Therefore, as an alternative to the presentation indicated in the preceding paragraph, the provision for renegotiation refund may be shown as a charge in the income statement, separately from the provision for taxes on income, or in combination therewith.

RENEGOTIATION REFUNDS FOR PRIOR YEARS

9. A further question arises where a renegotiation refund applicable to a particular year is made in an amount materially different from the provision made in the financial statements originally issued for such year. The committee recommends that the difference between the renegotiation refund and the provision therefor be shown as a separate item in the current income statement, unless such inclusion would result in a distortion of the current net income, in which event the adjustment should be treated as an adjustment of earned surplus.[3] Where an adjustment of earned surplus is made there should be appropriate disclosure of the effect of the adjustment on the prior year's net income. The committee believes that a major retroactive adjustment of the provision made for a renegotiation refund can often best be disclosed by presenting a revised income statement for the prior year, either in comparative form in conjunction with the current year's financial statements[4] or otherwise, and it urges that this procedure be followed.

Section C—Terminated War and Defense Contracts

1. This section deals with problems involved in accounting for fixed-price war and defense supply contracts terminated, in whole or in part, for the convenience of the government. It does not deal specifically with terminated cost-plus-fixed-fee contracts nor with contracts for facilities or services. However, the conclusions reached herein may serve as guides for the accounting applicable to such special contracts. Terminations for default of the contractor involve problems of a different nature and are not considered here.

2. Except where the text clearly indicates otherwise, the term *contractor* is used to denote either a prime contractor or a subcontractor, and the term *contract* to denote either a prime contract or a subcontract.

SUMMARY STATEMENT

3. The profit of a contractor on a fixed-price supply contract terminated for the convenience of the government accrues as of the effective date of termination.

4. Those parts of the termination claim which are reasonably determinable should be included in financial statements after termination; when the total of the undeterminable elements is believed to be material, full disclosure of the essential facts should be made, by footnote or otherwise.

5. Under ordinary circumstances the termination claim should be classified as a current asset and unless the amount is relatively small should be separately disclosed.

6. Advances received on the contract before its termination may be shown in financial statements after termination as a deduction from the claim receivable and should be appropriately explained. Loans negotiated on the security of the termination claim, however, should be shown as current liabilities.

7. All of the contractor's own cost and profit elements included in the termination claim are preferably accounted for as a sale and if material in amount should be separately disclosed. The costs and expenses chargeable to the claim may then be given their usual classification in the accounts.

[3] See chapter 8, paragraphs 11, 12, and 13.

[4] See chapter 2(a).

8. When inventory items whose costs are included in the termination claim are subsequently reacquired by the contractor the reacquisition value of those items should be recorded as a purchase and applied, together with other disposal credits, against the termination claim receivable.

9. So-called *no-cost* settlements—those in which the contractor waives the right to make a claim—result in no transaction which could be reflected in sales. The costs applicable to the contract may be given their usual classification in the accounts; the inventory retained should not be treated as a purchase but should be accounted for according to the usual methods and standards applicable to inventories.

DISCUSSION

10. Termination of war and defense contracts for the convenience of the government is a means of adjusting the production of materials to the varying requirements of the military services. Since terminations transfer active contracts in process of execution into claims in process of liquidation, they, like contract renegotiations and cost-plus-fixed-fee contracts, may have important effects on the financial statements of defense contractors.

When Profit Accrues

11. An important problem involved in accounting for the effect of terminations is that of determining the time at which profit earned on the contract should be recognized. This problem is similar to that described in other sections of this chapter on renegotiation and cost-plus-fixed-fee contracts in that it involves accrual at a specific date of an element of profit whose original measurement may be difficult and will require informed judgment, and whose final amount may not be determined until some future period.

12. Three dates have been mentioned as dates for the determination of profit from terminated contracts: (a) the effective date of termination; (b) the date of final settlement; and (c) some intermediate date, such as that on which the claim is finally prepared or filed. The effective date of termination is the date at which the contractor acquires the right to receive payment on the terminated portion of the contract. This date is also, of the three, the one most objectively determined.

13. Under the accrual basis of accounting recognition is given to revenues and expenses, to the fullest extent possible, in the period to which they relate. Profit on a contract of sale is ordinarily taken into account upon delivery or performance. However, as stated in section (a) of this chapter it is a generally accepted accounting procedure to accrue revenues under certain types of contracts, and thereby recognize profits, on the basis of partial performance where the circumstances are such that total profit can be estimated with reasonable accuracy and ultimate realization is reasonably assured. Thus, the accrual of profit under a cost-plus-fixed-fee contract is recognized as the fee becomes billable rather than when it is actually billed. Upon termination of a contract the contractor acquires a claim for fair compensation; the government reserves the option of acquiring any of the inventories for which the contractor makes claim under the terminated contract. Except to effect settlements and to protect and dispose of property, the expenses of which are reimbursable, the contractor need perform no further service under a terminated contract in order to enforce his claim. It follows that any profit arising out of such a contract accrues at the effective date of termination and, if the amount can be reasonably ascertained, should be recorded at that time.

Determination of Claim

14. Practical application of the accrual principle to the accounting for terminated war and defense contracts rests upon the possibility of making a reasonable estimate of the amount of the termination claim before its final determination by settlement. This involves two principal considerations: (1) whether the costs of the contractor can be determined with reasonable accuracy and (2) whether the amount of profit to be realized can be estimated closely enough to justify inclusion in the accounts.

15. The various acts and regulations, including a statement of principles for determining costs and certain termination cost memorandums, describe in general terms the costs and expenses which are to be taken into account in arriving at fair compensation, as well as certain costs which are not allowable, and establish uniform termination policies and procedures.

16. While the total claim, and particularly the profit allowance, is subject to negotiation, the termination articles provide for a

formula settlement allowing definite percentages of profit based on costs in the event of the failure of negotiations. This in effect fixes a minimum expectation of profit allowance since the formula percentages have also been recognized by regulation as a basis of negotiating settlement in the event of failure by the parties to agree on any other basis. The same regulations give other guides for estimating a fair profit allowance, which in some cases may be greater than the amount computed by the formula percentages. When the contractor, because of lack of prior negotiation experience or uncertainty as to the application of the principles of these regulations to a particular case, is unable to determine a more appropriate profit allowance, he may accrue the minimum amount determined by the formula percentages.

17. The profit to be included in the accounts of the contractor upon termination is the difference between (a) the amount of his recorded claim and (b) the total of the inventory, deferred and capitalized items, and other costs applicable to the terminated contract as they are currently included in his accounts. This profit may exceed the amount specified as profit in the claim because costs applicable to the terminated portion of the contract may be allowable in the claim even though they may have been properly written off as incurred in prior periods.

18. In some cases it will be impossible to make a reasonable estimate of a termination claim in time for inclusion in the financial statements of the period in which the termination occurs. Effect may then be given in the statements to those parts of the termination claim which are determinable with reasonable certainty and disclosure made, by footnote or otherwise, of the status of the remainder.

19. When the contractor's claim includes items of known controversial nature it should be stated at the amount estimated to be collectible. When a particular termination claim or part thereof is so uncertain in amount that it cannot be reasonably estimated, it is preferable not to give effect to that part of the claim in the financial statements; but if the total of such undeterminable elements is material, the circumstances should be disclosed in statements issued before the removal of the uncertainty. In an extreme case involving undeterminable claims, consideration should be given to delaying the issuance of financial statements until necessary data are available.

Presentation in Financial Statements

20. Termination has the effect of converting an active contract in process into a claim, or, from an accounting standpoint, from inventories and other charges into an account receivable. This receivable arises in the regular course of business; it is part of the working capital; and in view of the provisions made for financial assistance to the contractor during the period of termination, collection in large part may be expected within a relatively short time. The termination claim should therefore be classified as a current asset, unless there is an indication of extended delay, such as serious disagreement pointing to probable litigation, which would exclude it from this classification.

21. Although a claim may be composed of several elements representing reimbursable items of special equipment, deferred charges, inventories, and other items, as well as claims for profit, it is preferable to record the claim in one account. When the total of termination claims is material it should be disclosed separately from other receivables. It is also desirable to segregate claims directly against the government from claims against other contractors where the amounts are significant.

22. To assure adequate financial assistance to contractors, the acts provide in some cases for partial payments and in others for such payments or guaranteed loans from the effective date of termination until final settlement. Partial payments are, of course, to be recorded as reductions of the termination claim receivable. Termination loans, on the other hand, are definite liabilities to third parties, even though guaranteed in whole or in part by the government, and accordingly should be shown in the balance sheet as liabilities, with appropriate cross-reference to the related claim or claims. When a terminated contract is one on which advance payments had previously been received, the financial statements of the contractor issued before final collection of the claim ordinarily should reflect any balance of those advances disclosed as deductions from the claim receivable.[1] Financial statements issued before the termination claim is recorded should disclose, by footnote or otherwise, the relationship of such liabilities to a possible termination claim receivable.

[1] See chapter 11(a), paragraph 22.

23. Ordinarily, a termination will result in the cessation of a contractor's activity through which materials or services have been supplied under the contract and of the related transactions which have been reflected in the contractor's income accounts as sales and cost elements. In effect, termination policies and procedures provide a basis upon which the contractor's costs in process may become the elements of a final sale under the terminated portion of the contract. Accordingly, the amount of the contractor's termination claim representing his cost and profit elements should be treated as a sale and the costs and expenses chargeable to the claim given their usual classification in the income statement. Because these termination sales are of a special type, their financial results should not be appraised in the same manner as are those of regular sales and they should, if material in amount, be separately disclosed in the income statement. Any items which the contractor chooses to retain without claim for cost or loss are, of course, not sold but remain as inventory or deferred charges in the contractor's accounts.

Claims of Subcontractors

24. The term *subcontractor's claims* as used in connection with terminated contracts refers to those obligations of a contractor to a subcontractor which arise from the subcontractor's costs incurred through transactions which were related to the contract terminated but did not result in the transfer of billable materials or services to the contractor before termination. Other obligations of a contractor to a subcontractor, arising through transactions by which materials or services of the subcontractor are furnished or supplied to the contractor, are considered to be liabilities incurred in the ordinary course of business and are not included in the term *claims of subcontractors.*

25. The termination articles provide that, following the termination of a contract, the contractor shall settle, with the approval or ratification of the contracting officer when necessary, all claims of subcontractors arising out of the termination; and that the contractor shall be paid, as part of his settlement, the cost of settling and paying claims arising out of the stoppage of work under subcontracts affected by the termination. While a contractor ordinarily is liable to his subcontractors or suppliers for such obligations, the amounts due them are an element in his termination claim and often are not paid to them until after his claim has been settled. He often has no control over the filing of subcontractors' claims and may not know their amount until some time after the termination date or even until some time after he has filed and received payment for his own claim.

26. The possibility that a contractor may suffer loss through failure to recover the amount of his liability on subcontractors' claims arises principally from overcommitments, errors in ordering, and similar causes. Provision should be made in his accounts for losses of this character which are known or believed to be probable.

27. Although the principle that liabilities may not be offset against assets in the financial statements is generally approved by accountants, there is no general agreement as to the accounting treatment to be accorded subcontractors' claims which are expected to be fully recoverable. To the extent that a subcontractor's claim is considered to be unrecoverable no difference of opinion exists; the liability should be recorded and provision made for any contemplated loss. The difference of opinion relates to those subcontractors' claims which are deemed to be fully recoverable.

28. Some accountants believe that the effect of the various acts and regulations is to establish a relationship between the claims of subcontractors and the resulting right of the contractor under his own termination claim which differs from an ordinary commercial relationship and justifies their omission from the accounts. Recoverable subcontractors' claims are thus said to be in the nature of contingent liabilities, which are customarily omitted from the accounts except where a loss is expected. Contingent liabilities may be disclosed in the financial statements without recording them as assets and liabilities, and even when they are recorded it is customary accounting practice to show them on the balance sheet as deductions from the related contingent assets so that no effect upon financial ratios and relationships results.

29. Other accountants believe that the nature of an obligation to a subcontractor is that of an ordinary liability, even though it may arise through the termination of a war or defense contract, and that the contractor's termination claim receivable, although related to the subcontractor's claim, is to be accounted for independently as an asset. This group believes that all subcontractors' claims, to the extent that they are reasonably ascertainable, should be recorded in the accounts and displayed in the contrac-

tor's balance sheet as current liabilities, and that the amounts recoverable by the contractor should be included in his termination claim receivable. To the extent that the amounts of subcontractors' claims are not reasonably determinable, disclosure by footnote or otherwise in the financial statements is believed to be adequate.

30. Because of the merits and prevalence of these alternative views, the committee expresses no preference for either treatment and considers either to be acceptable.

Disposal Credits

31. Disposal credits are amounts deducted from the contractor's termination claim receivable by reason of his retention, or sale to outsiders, of some or all of the termination inventory for which claim was made. In the case of items retained, either as scrap or for use by the contractor, the amount of the credit is determined by agreement between the contractor and a representative of the government. The sale of inventory items by the contractor is likewise subject to approval by the government, except as permitted by regulation. Since the amount of the contractor's termination claim, as already indicated, is properly recorded as a sale, any elements included in that claim for items of inventory retained by the contractor are, in effect, reacquired by him and should be treated as purchases at the agreed value. Amounts received for items sold to others with the approval of the government are collections for the account of the government and should be applied in reduction of the claim receivable. Obviously inventories or other items that are retained by the contractor after termination without claim for loss should not be included as an element of the termination claim.

No-Cost Settlements

32. A contractor whose contract is terminated may prefer to retain the termination inventory for use in other production or for disposal at his own risk. For these or other reasons the contractor may prefer to make no claim against the government or a higher-tier contractor. In the case of such no-cost settlements there is no sale of inventory or other items to the government and therefore no occasion to accrue any profit arising out of the termination. The costs otherwise applicable to the contract should be given their usual treatment in the accounts. Items of inventory or other property retained, having been previously recorded, will, of course, require no charge to purchases but should be treated in accordance with the usual procedures applicable to such assets.

CHAPTER 12

Foreign Operations and Foreign Exchange

1. The recommendations made in this chapter apply to United States companies which have branches or subsidiaries operating in foreign countries.

2. Since World War I foreign operations have been influenced to a marked degree by wars, departures from the gold standard, devaluations of currencies, currency restrictions, government regulations, etc.

3. Although comparatively few countries in recent years have had unrestricted currencies and exchanges, it is nevertheless true that many companies have been doing business in foreign countries having varying degrees of restrictions; in some cases they have been carrying on all operations regarded as normal, including the transmission of funds. In view of the difficulties mentioned above, however, the accounting treatment of assets, liabilities, losses, and gains involved in the conduct of foreign business and to be included or reflected in the financial statements of United States companies requires careful consideration.

4. A sound procedure for United States companies to follow is to show earnings from foreign operations in their own accounts only to the extent that funds have been received in the United States or unrestricted funds are available for transmission thereto. Appropriate provision should be made also for known losses.

5. Any foreign earnings reported beyond the amounts received in the United States should be carefully considered in the light of all the facts. The amounts should be disclosed if they are significant, and they should be reserved against to the extent that their realization in dollars appears to be doubtful.

6. As to assets held abroad, the accounting should take into consideration the fact

that most foreign assets stand in some degree of jeopardy, so far as ultimate realization by United States owners is concerned. Under these conditions it is important that especial care be taken in each case to make full disclosure in the financial statements of United States companies of the extent to which they include significant foreign items.

7. Where more than one foreign exchange rate is in effect, care should be exercised to select the one most clearly realistic and appropriate in the circumstances.

CONSOLIDATION OF FOREIGN SUBSIDIARIES

8. In view of the uncertain values and availability of the assets and net income of foreign subsidiaries subject to controls and exchange restrictions and the consequent unrealistic statements of income that may result from the translation of many foreign currencies into dollars, careful consideration should be given to the fundamental question of whether it is proper to consolidate the statements of foreign subsidiaries with the statements of United States companies. Whether consolidation of foreign subsidiaries is decided upon or not, adequate disclosure of foreign operations should be made.

9. The following are among the possible ways of providing information relating to such foreign subsidiaries:

(a) To exclude foreign subsidiaries from consolidation and to furnish (1) statements in which only domestic subsidiaries are consolidated and (2) as to foreign subsidiaries, a summary in suitable form of their assets and liabilities, their income and losses for the year, and the parent company's equity therein. The total amount of investments in foreign subsidiaries should be shown separately, and the basis on which the amount was arrived at should be stated. If these investments include any surplus of foreign subsidiaries and such surplus had previously been included in consolidated surplus, the amount should be separately shown or earmarked in stating the consolidated surplus in the statements here suggested. The exclusion of foreign subsidiaries from consolidation does not make it acceptable practice to include intercompany profits which would be eliminated if such subsidiaries were consolidated.

(b) To consolidate domestic and foreign subsidiaries and to furnish in addition the summary described in (a)(2) above.

(c) To furnish (1) complete consolidated statements and also (2) consolidated statements for domestic companies only.

(d) To consolidate domestic and foreign subsidiaries and to furnish in addition parent company statements showing the investment in and income from foreign subsidiaries separately from those of domestic subsidiaries.

LOSSES AND GAINS ON FOREIGN EXCHANGE

10. Realized losses or gains on foreign exchange should be charged against or credited to operations.

11. Provision should be made, ordinarily by a charge against operations, for declines in translation value of foreign net current and working assets (unrealized losses). Unrealized gains should preferably be carried to a suspense account, except to the extent that they offset prior provisions for unrealized losses, in which case they may be credited to the account previously charged.

TRANSLATION OF ASSETS, LIABILITIES, LOSSES, AND GAINS

Balance Sheet

12. Fixed assets, permanent investments, and long-term receivables should be translated into dollars at the rates prevailing when such assets were acquired or constructed. When large items are purchased for United States dollars (or from the proceeds of sale of such dollars), the United States dollar cost will, of course, be used. If, however, the purchase is made in some foreign currency (obtained from earnings or borrowings), then the cost of the assets should be the equivalent of the amount of foreign currency in United States dollars, at the rate of exchange prevailing at the time payment is made. An exception to the foregoing general principle might be made where fixed assets, permanent investments, or long-term receivables were acquired shortly before a substantial and presumably permanent change in the exchange rate with funds obtained in the country concerned, in which case it may be appropriate to restate the dollar equivalents of such assets to the extent of the change in the related debt.

13. In consolidating or combining the accounts, depreciation should be computed on the amount of fixed assets as expressed in United States dollars, even though for purposes of local taxation it may be impossible to show the foreign currency equivalent of the full amount of depreciation on the foreign statements.

14. Cash, accounts receivable, and other current assets, unless covered by forward exchange contracts, should be translated at the rate of exchange prevailing on the date of the balance sheet.

15. Inventory should follow the standard rule of *cost or market, whichever is lower* in dollars. Where accounts are to be stated in which the question of foreign exchange enters and the inventory is not translated at the rate of exchange prevailing on the date of the balance sheet, as is usually done with current assets, the burden of proof is on those who wish to follow some other procedure.

16. There are, however, undoubtedly many cases where the cost or a portion of the cost of an article was incurred when the foreign currency was at a substantially higher rate of exchange than existed on the closing day of the financial period. In many cases such an asset could not be replaced for the amount in foreign currency at which it appears in the records of the branch or subsidiary company. In some cases the replacement price in foreign currency would undoubtedly have increased since the fall in exchange, and it would be inequitable to treat *the lower of cost or market* as a mere translation at the closing rate of the foreign currency cost price, where the article could now be replaced only at a much higher amount in foreign currency. Where the selling price obtainable in dollars, after deducting a reasonable percentage to cover selling and other local expenses, exceeds the cost of the article in dollars at the rate prevailing as of the date of purchase, such original dollar equivalent may be considered as the cost for purposes of inventory.

17. Current liabilities payable in foreign currency should be translated into dollars at the rate of exchange in force on the date of the balance sheet.

18. Long-term liabilities and capital stock stated in foreign currency should not be translated at the closing rate, but at the rates of exchange prevailing when they were originally incurred or issued. This is a general rule, but an exception may exist in respect to long-term debt incurred or capital stock issued in connection with the acquisition of fixed assets, permanent investments, or long-term receivables a short time before a substantial and presumably permanent change in the exchange rate. In such instances it may be appropriate to state the long-term debt or the capital stock at the new rate and proper to deal with the exchange differences as an adjustment of the cost of the assets acquired.

Profit and Loss Statement

19. The operating statements of foreign branches or subsidiaries, or of domestic corporations conducting their business in foreign currencies (buying, selling and manufacturing), should preferably, where there have been wide fluctuations in exchange, be translated at the average rate of exchange applicable to each month or, if this procedure would involve too much labor, on the basis of a carefully weighted average.

20. Where a major change in an exchange rate takes place during a fiscal year, there may be situations in which more realistic results will be obtained if income computed in foreign currencies is translated for the entire fiscal year at the new rates in effect after such major fluctuation. This procedure would have the practical advantage of making unnecessary a cutoff at the date of the change in the exchange rate. Where dividends have been paid prior to a major change in the exchange rate, out of earnings of the current fiscal year, that portion of the income for the year should be considered as having been earned at the rate at which such dividend was paid irrespective of the rates used in translating the remainder of the earnings.

21. While the possibility of losses from currency devaluation may ordinarily be considered to be a risk inherent in the conduct of business in foreign countries, the world-wide scope and unprecedented magnitude of devaluations that have occurred in recent years are such that they cannot be regarded as recurrent hazards of business. Accordingly, exchange adjustments arising from such extraordinary developments, if so material in amount that their inclusion in the income statement would impair the significance of net income to an extent that misleading inferences might be drawn therefrom, appear to be of such nature that they might appropriately be charged to surplus.

* * *

22. The foregoing is no more than a brief résumé of the generally accepted prin-

ciples pertaining to the treatment of foreign exchange as applied to the statements of accounts of American corporations. The practical problems which arise in their application should receive careful consideration in each case.

Two members of the committee, Messrs. Lindquist and Mason, assented with qualification to adoption of chapter 12.

Mr. Lindquist believes that the accounting indicated in paragraph 11 for unrealized losses and gains arising from exchange fluctuations should be consistent for losses and gains to the extent that they result from normal temporary fluctuations in exchange rates.

Mr. Mason does not approve the inconsistent treatment of unrealized losses and unrealized gains from exchange fluctuations. He would prefer to defer them both. He also believes that long-term receivables and long-term liabilities should be translated at current rates.

CHAPTER 13 Compensation

Section A—Pension Plans: Annuity Costs Based on Past Service

1. This section deals with the accounting treatment of costs arising out of past service which are incurred under pension plans involving payments to outside agencies such as insurance companies and trustees. Self-administered and informal plans which do not require payments to outside agencies are not dealt with because of their special features and lack of uniformity. The principles set forth herein, however, are generally applicable to those plans as well.

2. Charges with respect to pension costs based on past service have sometimes been made to surplus on the ground that such payments are indirectly compensation for services and that since the services upon which computation of the payments is based were performed in the past, the compensation should not be permitted to affect any period or periods other than those in which the services involved were performed. In other cases all annuity costs based on past service have been charged to income in the period of the plan's inauguration as a current cost of originating the plan. In still other cases the position has been taken that a pension plan cannot bring the hoped-for benefits in the future unless past as well as future services are given recognition and, accordingly, annuity costs based on past service have been spread over a period of present and future years. The last method is the one permitted under provisions of the Internal Revenue Code.[1]

3. The committee believes that, even though the calculation is based on past service, costs of annuities based on such service are incurred in contemplation of present and future services, not necessarily of the individual affected but of the organization as a whole, and therefore should be charged to the present and future periods benefited. This belief is based on the assumption that although the benefits to a company flowing from pension plans are intangible, they are nevertheless real. The element of past service is one of the important considerations in establishing pension plans, and annuity costs measured by such past service contribute to the benefits gained by the adoption of a plan. It is usually expected that such benefits will include better employee morale, the removal of superannuated employees from the payroll, and the attraction and retention of more desirable personnel, all of which should result in improved operations.

4. The committee, accordingly, is of the opinion that:

(a) Costs of annuities based on past service should be allocated to current and future periods; however, if they are not sufficiently material in amount to distort the results of operations in a single period, they may be absorbed in the current year;

(b) Costs of annuities based on past service should not be charged to surplus.

5. This opinion is not to be interpreted as requiring that charges be made to income rather than to reserves previously provided, or that recognition be given in the accounts of current or future periods to pension costs written off prior to the issuance of an opinion on this subject.

[1] See IRC Sec. 23(p)(1)(A).

Section B—Compensation Involved in Stock Option and Stock Purchase Plans

1. The practice of granting to officers and other employees options to purchase or rights to subscribe for shares of a corporation's capital stock has been followed by a considerable number of corporations over a period of many years. To the extent that such options and rights involve a measurable amount of compensation, this cost of services received should be accounted for as such. The amount of compensation involved may be substantial and omission of such costs from the corporation's accounting may result in overstatement of net income to a significant degree. Accordingly, consideration is given herein to the accounting treatment of compensation represented by stock options or purchase rights granted to officers and other employees.[1]

2. For convenience, this section will discuss primarily the problems of compensation raised by stock option plans. However, the committee feels that substantially the same problems may be encountered in connection with stock purchase plans made available to employees, and the discussion below is applicable to such plans also.

RIGHTS INVOLVING COMPENSATION

3. Stock options involving an element of compensation usually arise out of an offer or agreement by an employer corporation to issue shares of its capital stock to one or more officers or other employees (hereinafter referred to as grantees) at a stated price. The grantees are accorded the right to require issuance of the shares either at a specified time or during some determinable period. In some cases the grantee's options are exercisable only if at the time of exercise certain conditions exist, such as that the grantee is then or until a specified date has been an employee. In other cases, the grantees may have undertaken certain obligations, such as to remain in the employment of the corporation for at least a specified period, or to take the shares only for investment purposes and not for resale.

RIGHTS NOT INVOLVING COMPENSATION

4. Stock option plans in many cases may be intended not primarily as a special form of compensation but rather as an important means of raising capital, or as an inducement to obtain greater or more widespread ownership of the corporation's stock among its officers and other employees. In general, the terms under which such options are granted, including any conditions as to exercise of the options or disposal of the stock acquired, are the most significant evidence ordinarily available as to the nature and purpose of a particular stock option or stock option plan. In practice, it is often apparent that a particular option or plan involves elements of two or more of the above purposes. Where the inducements are not larger per share than would reasonably be required in an offer of shares to all shareholders for the purpose of raising an equivalent amount of capital, no compensation need be presumed to be involved.

5. Stock purchase plans also are frequently an integral part of a corporation's program to secure equity capital or to obtain widespread ownership among employees, or both. In such cases, no element of compensation need be considered to be present if the purchase price is not lower than is reasonably required to interest employees generally or to secure the contemplated funds.

[1] Bulletin 37, "Accounting for Compensation in the Form of Stock Options," was issued in November, 1948. Issuance of a revised bulletin in 1953 and its expansion to include stock purchase plans were prompted by the very considerable increase in the use of certain types of option and purchase plans following the enactment in 1950 of Section 130A of the Internal Revenue Code. This section granted specialized tax treatment to employee stock options if certain requirements were met as to the terms of the option, as to the circumstances under which the option was granted and could be exercised and as to the holding and disposal of the stock acquired thereunder. In general, the effect of Section 130A is to eliminate or minimize the amount of income taxable to the employee as compensation and to deny to the issuing corporation any tax deduction in respect of such restricted options. In 1951, the Federal Salary Stabilization Board issued rules and regulations relating to stock options and purchase rights granted to employees whereby options generally comparable in nature to the restricted stock options specified in Section 130A might be considered for its purposes not to involve compensation, or to involve compensation only in limited amounts.

TIME OF MEASUREMENT OF COMPENSATION

6. In the case of stock options involving compensation, the principal problem is the measurement of the compensation. This problem involves selection of the date as of which measurement of any element of compensation is to be made and the manner of measurement. The date as of which measurement is made is of critical importance since the fair value of the shares under option may vary materially in the often extended period during which the option is outstanding. There may be at least six dates to be considered for this purpose: (a) the date of the adoption of an option plan, (b) the date on which an option is granted to a specific individual, (c) the date on which the grantee has performed any conditions precedent to exercise of the option, (d) the date on which the grantee may first exercise the option, (e) the date on which the option is exercised by the grantee, and (f) the date on which the grantee disposes of the stock acquired.

7. Of the six dates mentioned two are not relevant to the question considered in this bulletin—cost to the corporation which is granting the option. The date of adoption of an option plan clearly has no relevance, inasmuch as the plan per se constitutes no more than a proposed course of action which is ineffective until options are granted thereunder. The date on which a grantee disposes of the shares acquired under an option is equally immaterial since this date will depend on the desires of the individual as a shareholder and bears no necessary relation to the services performed.[3]

8. The date on which the option is exercised has been advocated as the date on which a cost may be said to have been incurred. Use of this date is supported by the argument that only then will it be known whether or not the option will be exercised. However, beginning with the time at which the grantee may first exercise the option he is in effect speculating for his own account. His delay has no discernible relation to his status as an employee but reflects only his judgment as an investor.

9. The date on which the grantee may first exercise the option will generally coincide with, but in some cases may follow, the date on which the grantee will have performed any conditions precedent to exercise of the option. Accordingly this date presents no special problems differing from those to be discussed in the next paragraph.

10. There remain to be considered the date on which an option is granted to a specific individual and the date on which the grantee has fulfilled any conditions precedent to exercise of the option. When compensation is paid in a form other than cash the *amount* of compensation is ordinarily determined by the fair value of the property which was agreed to be given in exchange for the services to be rendered. The time at which such fair value is to be determined may be subject to some difference of opinion but it appears that the date on which an option is granted to a specific individual would be the appropriate point at which to evaluate the cost to the employer, since it was the value at that date which the employer may be presumed to have had in mind. In most of the cases under discussion, moreover, the only important contingency involved is the continuance of the grantee in the employment of the corporation, a matter very largely within the control of the grantee and usually the main objective of the grantor. Under such circumstances it may be assumed that if the stock option were granted as a part of an employment contract, both parties had in mind a valuation of the option at the date of the contract; and accordingly, value at that date should be used as the amount to be accounted for as compensation. If the option were granted as a form of supplementary compensation otherwise than as an integral part of an employment contract, the grantor is nevertheless governed in determining the option price and the number of shares by conditions then existing. It follows that it is the value of the option at that time, rather than the grantee's ultimate gain or loss on the transaction, which for accounting purposes constitutes whatever compensation the grantor intends to pay. The committee therefore concludes that in most cases, including situations where the right to exercise is conditional upon continued employment, valuation should be made of the option as of the date of grant.

11. The date of grant also represents the date on which the corporation foregoes the principal alternative use of the shares which it places subject to option, i.e., the sale of such shares at the then prevailing

[3] This is the date on which income or gain taxable to the grantee may arise under Section 130A. Use of this date for tax purposes is doubtless based on considerations as to the ability of the optionee to pay taxes prior to sale of the shares.

market price. Viewed in this light, the *cost* of utilizing the shares for purposes of the option plan can best be measured in relation to what could then have been obtained through sale of such shares in the open market. However, the fact that the grantor might, as events turned out, have obtained at some later date either more or less for the shares in question than at the date of the grant does not bear upon the measurement of the compensation which can be said to have been in contemplation of the parties at the date the option was granted.

MANNER OF MEASUREMENT

12. Freely exercisable option rights, even at prices above the current market price of the shares, have been traded in the public markets for many years, but there is no such objective means for measuring the value of an option which is not transferable and is subject to such other restrictions as are usually present in options of the nature here under discussion. Although there is, from the standpoint of the grantee, a value inherent in a restricted future right to purchase shares at a price at or even above the fair value of shares at the grant date, the committee believes it is impracticable to measure any such value. As to the grantee any positive element may, for practical purposes, be deemed to be largely or wholly offset by the negative effect of the restrictions ordinarily present in options of the type under discussion. From the viewpoint of the grantor corporation no measurable cost can be said to have been incurred because it could not at the grant date have realized more than the *fair value* of the optioned shares, the concept of fair value as here used encompassing the possibility and prospect of future developments. On the other hand, it follows in the opinion of the committee that the value to the grantee and the related cost to the corporation of a restricted right to purchase shares at a price *below* the fair value of the shares at the grant date may for the purposes here under discussion be taken as the excess of the then fair value of the shares over the option price.

13. While market quotations of shares are an important and often a principal factor in determining the fair value of shares, market quotations at a given date are not necessarily conclusive evidence.[3] Where significant market quotations cannot be obtained, other recognized methods of valuation have to be used. Furthermore, in determining the fair value of shares for the purpose of measuring the cost incurred by a corporation in the issuance of an option, it is appropriate to take into consideration such modifying factors as the range of quotations over a reasonable period and the fact that the corporation by selling shares pursuant to an option may avoid some or all of the expenses otherwise incurred in a sale of shares. The absence of a ready market, as in the case of shares of closely-held corporations, should also be taken into account and may require the use of other means of arriving at fair value than by reference to an occasional market quotation or sale of the security.

OTHER CONSIDERATIONS

14. If the period for which payment for services is being made by the issuance of the stock option is not specifically indicated in the offer or agreement, the value of the option should be apportioned over the period of service for which the payment of the compensation seems appropriate in the existing circumstances. Accrual of the compensation over the period selected should be made by means of charges against the income account. Upon exercise of an option the sum of the cash received and the amount of the charge to income should be accounted for as the consideration received on issuance of the stock.

15. In connection with financial statements, disclosure should be made as to the status of the option or plan at the end of the period of report, including the number of shares under option, the option price, and the number of shares as to which options were exercisable. As to options exercised during the period, disclosure should be made of the number of shares involved and the option price thereof.

[3] Whether treasury or unissued shares are to be used to fulfill the obligation is not material to a determination of value.

One member of the committee, Mr. Mason, assented with qualification to adoption of section (b) of chapter 13. One member, Mr. Knight, did not vote.

Mr. Mason assents only under the assumption that if an option lapses after the grantee becomes entitled to exercise it, the related compensation shall be treated as a contribution by the grantee to the capital of the grantor.

CHAPTER 14 Disclosure of Long-Term Leases in Financial Statements of Lessees

1. The growth in recent years of the practice of using long-term leases as a method of financing has created problems of disclosure in financial statements. In buy-build-sell-and-lease transactions, the purchaser of land builds to his own specifications, sells the improved property, and simultaneously leases the property for a period of years. Similar transactions are the sale and lease of existing properties or the lease of properties to be constructed by the lessor to the specifications of the lessee. The lessee ordinarily assumes all the expenses and obligations of ownership (such as taxes, insurance, interest, maintenance, and repairs) except payment of any mortgage indebtedness on the property.

2. There are many variations in such types of transactions. For example, some leases contain an *option* for acquisition of the property by the lessee, while other leases contain a *requirement* that the lessee purchase the property upon expiration of the lease. In some the price to be paid upon repurchase is related to the fair value of the property or the depreciated book value; in others it is an arbitrary amount with little or no relation to the property's worth, or a nominal sum. Some leases provide for a high initial rental with declining payments thereafter or renewal at substantially reduced rentals.

3. Where long-term leases are used as a substitute for ownership and mortgage borrowing a question arises as to the extent of disclosure to be made in financial statements of the fixed annual amounts payable and other important terms under such leases.[1]

4. Although the types of sell-and-lease arrangements referred to in paragraph 1 differ in many respects from the conventional long-term lease,[2] the principles of disclosure stated herein are intended to apply to both. This chapter does not apply to short-term leases[3] or to those customarily used for oil and gas properties.

5. The committee believes that material amounts of fixed rental and other liabilities maturing in future years under long-term leases and possible related contingencies are material facts affecting judgments based on the financial statements of a corporation, and that those who rely upon financial statements are entitled to know of the existence of such leases and the extent of the obligations thereunder, irrespective of whether the leases are considered to be advantageous or otherwise. Accordingly, where the rentals or other obligations under long-term leases are material in the circumstances, the committee is of the opinion that:

(a) disclosure should be made in financial statements or in notes thereto of:

(1) the amounts of annual rentals to be paid under such leases with some indication of the periods for which they are payable and

(2) any other important obligation assumed or guarantee made in connection therewith;

(b) the above information should be given not only in the year in which the transaction originates but also as long thereafter as the amounts involved are material; and

(c) in addition, in the year in which the transaction originates, there should be disclosure of the principal details of any important sale-and-lease transaction.

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[1] Rule 3-18 (b) of Regulation S-X issued by the Securities and Exchange Commission reads: "Where the rentals or obligations under long-term leases are material there shall be shown the amounts of annual rentals under such leases with some indication of the periods for which they are payable, together with any important obligation assumed or guarantee made in connection therewith. If the rentals are conditional, state the minimum annual amounts."

[2] The conventional lease, a straight tenure contract between the owner of property and a lessee, generally does not involve buying, building, and selling of property by the lessee, or special repurchase arrangements.

[3] Three years has been used as a criterion in some cases for classifying leases as short-term or long-term.

6. A lease arrangement is sometimes, in substance, no more than an instalment purchase of the property. This may well be the case when the lease is made subject to purchase of the property for a nominal sum or for an amount obviously much less than the prospective fair value of the property; or when the agreement stipulates that the rental payments may be applied in part as instalments on the purchase price; or when the rentals obviously are so out of line with rentals for similar properties as to negative the representation that the rental payments are for current use of the property and to create the presumption that portions of such rentals are partial payments under a purchase plan.

7. Since the lessee in such cases does not have legal title to the property and does not necessarily assume any direct mortgage obligation, it has been argued that any balance sheet which included the property among the assets and any related indebtedness among the liabilities would be incorrect. However, the committee is of the opinion that the facts relating to all such leases should be carefully considered and that, where it is clearly evident that the transaction involved is in substance a purchase, the "leased" property should be included among the assets of the lessee with suitable accounting for the corresponding liabilities and for the related charges in the income statement.

One member of the committee, Mr. Lindquist, assented with qualification to adoption of chapter 14.

Mr. Lindquist's qualification relates to paragraph 6. He believes that at any time during a long-term lease, other than a reasonable period before its expiration, no determination is possible as to *prospective fair value of the property* for comparison with the purchase price that may be stated in the lease. He also questions the ability of an accountant to carry out the implicit requirement for comparison of the lease rental with *rentals for similar properties* in view of the many physical and other factors on which would rest a conclusion of similarity of properties.

CHAPTER 15 Unamortized Discount, Issue Cost, and Redemption Premium on Bonds Refunded

1. Until the early days of the century, bond discount was commonly regarded as a capital charge. When the unsoundness of this treatment was recognized, alternative methods of treatment became accepted, under one of which the discount was distributed over the term of the issue, and under the other the discount was charged immediately against surplus, the latter being regarded generally as the preferable course.

2. Present-day treatment recognizes that on an issue of bonds the amount agreed to be paid (whether nominally as interest or as principal) in excess of the net proceeds constitutes the compensation paid for the use of the money. Where bonds are issued at a discount it is customary to distribute the discount over the term of the bond issue and to charge both the coupon interest and the allocated discount directly to income.

3. In the committee's opinion it is a sound accounting procedure to treat such discount as a part of the cost of borrowed money to be distributed systematically over the term of the issue and charged in successive annual income accounts of the company. The anticipation of this income charge by a debit to income of a previous year or to surplus has in principle no more justification than would a corresponding treatment of coupons due in future years.

4. The argument advanced in favor of immediately writing off discount was that it extinguished an asset that was only nominal in character and that it resulted in a conservative balance sheet. The weight attached to this argument has steadily diminished, and increasing weight has been given to the arguments that all such charges should be reflected under the proper head in the income account, and that conservatism in the balance sheet is of dubious value if attained at the expense of a lack of conservatism in the income account, which is far more significant.

TREATMENT OF UNAMORTIZED DISCOUNT, ISSUE COST, AND REDEMPTION PREMIUM ON BONDS REFUNDED

5. Discussion of the treatment of unamortized discount, issue cost, and redemption premium on bonds refunded (hereinafter referred to as unamortized discount) has revolved mainly about three methods of disposing of the unamortized balance:

(a) A direct write-off to income or earned surplus,

(b) Amortization over the remainder of the original life of the issue retired, or

(c) Amortization over the life of the new issue.

Each of these methods has had support in court decisions, in determinations by regulatory agencies, and in accounting literature. The reasoning and conclusions reached by the committee in regard to them are given here.

Direct Write-Off

6. It is acceptable accounting to write off unamortized discount in full in the year of refunding. This treatment is based on the view that the unamortized bond discount represents in effect the cost of the privilege of terminating a borrowing contract which has become disadvantageous and hence comes under the accounting doctrine that a loss or expense should be recognized as such not later than the time when the series of transactions giving rise to it is completed.

7. The decision as to whether a direct write-off of unamortized bond discount is to be made by a charge to income or to earned surplus should be governed by the criteria set forth in chapter 8, paragraphs 11, 12, and 13. Where a write-off is made to earned surplus it should be limited to the excess of the unamortized discount over the reduction of current taxes to which the refunding gives rise.[1]

Amortization Over Remainder of Original Life of Retired Issue

8. The second alternative, distributing the charge over the remainder of the original life of the bonds refunded, has strong support in accounting theory. Its chief merit lies in the fact that it results in reflection of the refinancing expense as a direct charge under the appropriate head in a series of income accounts related to the term of the original borrowing contract.

9. This method is based on the accounting doctrine that when a cost is incurred the benefits of which may reasonably be expected to be realized over a period in the future, it should be charged against income over such period. In behalf of this method, it is argued that the unamortized bond discount represents the cost of making a more advantageous arrangement for the unexpired term of the old agreement. In other words, such discount is regarded as the cost of an option included in the borrowing contract to enable a corporation to anticipate the maturity of its obligations if it finds it possible to refund them at a lower cost, either as the result of a favorable change in interest rates or as the result of its own improved credit. Continuing this line of reasoning, it is argued that the cost of money over the entire period of the original issue is affected by the terms of the original contract, and that if the cost of anticipating maturity is incurred, it is only because it is advantageous to do so; if the saving over the unexpired term of the old bonds will exceed the amount of unamortized discount to be disposed of, such discount should properly be spread over that unexpired term as a proper element of the cost of borrowed money.

10. This method should be regarded as preferable. It conforms more closely than any other method to current accounting opinion.

11. Where this method is adopted a portion of the unamortized discount equal to the reduction in current income tax resulting from the refunding should be deducted in the income statement and the remainder should be apportioned over the future period.[2]

Amortization Over Life of New Issue

12. The third alternative, amortization over the life of the new issue, runs counter to generally accepted accounting principles. It cannot be justified on the ground that cost may be spread over the period during which the benefit therefrom may be presumed to accrue. Clearly discernible benefits from a refunding accrue only for the period during which the new issue is replacing the previously outstanding issue. To determine whether any benefit will accrue to an issuing corporation for the period during which the new issue is to be outstanding after the maturity date of the old issue would require an ability to foresee interest rates to be in effect during that period. Since such fore-

[1] See chapter 10(b), paragraph 10.

[2] See chapter 10(b), paragraph 12.

sight is plainly impossible, there is no ground for assuming a benefit will result during that period. Moreover, the method does not possess any marked practical advantages in comparison with the second alternative. On the contrary, it results in an understatement of the annual cost of money after refunding and during the remainder of the term of the old issue, and consequently might tend to encourage consummation of transactions which are not, when properly viewed, advantageous. Furthermore, not only is there a lack of logical relationship between the amount of unamortized discount on the *old* issue and the term of the *new* issue, but also it is unconservative from both the balance-sheet and the income standpoints to carry forward part of the unamortized discount over the longer period. The committee considers the argument that the expense of retiring the old issue is a part of the cost of the new transaction to be untenable. In view of the above considerations the committee's conclusion is that this method is not acceptable.

OTHER CONSIDERATIONS

13. If the unamortized discount is carried forward after refunding it is acceptable to accelerate the amortization over a shorter period than that mentioned in paragraph 9, as long as the charge is made against income and is not in any year so large as seriously to distort the income figure for that year. Such acceleration may be regarded as a middle course between two alternatives (immediate writing off and spreading over the life of the old issue), each of which is acceptable, and, therefore, as being itself acceptable.

14. If the debt is to be paid off through a new issue with a term less than the remaining life of the old issue the amortization should be completed over the shorter period.

15. The method employed should be clearly disclosed, and if the unamortized discount is carried forward the amount of the annual charge should, if significant in amount, be shown separately from other charges for amortization of bond discount and expense.

16. The committee does not regard the charging of unamortized bond discount to capital surplus as an acceptable accounting treatment.

17. If the debt is discharged—otherwise than by refunding—before the original maturity date of the issue, any balance of discount and other issue cost then remaining on the books, and any redemption premium, should be written off at the date of such retirement by a charge against income, unless the amount is relatively so large as to fall within the provisions of chapter 8, paragraphs 11, 12, and 13.

Four members of the committee, Messrs. Peoples, Queenan, Werntz, and Williams, assented with qualification, and one member, Mr. Mason, dissented to adoption of chapter 15.

Messrs. Peoples, Queenan, Werntz, and Williams do not agree with the conclusions expressed in paragraph 12. They believe there are circumstances in which the unamortized discount and redemption premium applicable to an issue being refunded can properly be considered as a cost of the opportunity of issuing new bonds under more favorable terms. They believe there is support to be found in accounting theory and practice for this view. They further believe that it is inappropriate to disapprove this particular treatment and at the same time to approve the wide variety of treatments permitted by paragraphs 6 through 11, and paragraph 13.

Mr. Mason dissents since he believes that, with the exception of a public utility where an equitable result under regulatory procedures may call for the second alternative, the items under discussion should be a direct write-off to income or earned surplus, where lower interest rates have led to the refunding operation. If the refunding takes place in order to extend present interest rates in anticipation of higher rates in the future, the probable benefits would, in his opinion, justify spreading the costs over the life of the new issue.

APPENDIX A List of Accounting Research Bulletins With Cross-References

The following is a chronological list of Accounting Research Bulletins 1 through 42, which are now superseded. It indicates the chapter of the restatement containing each former bulletin, or portion thereof, as revised.

No.	*Date Issued*		*Title*	*Restatement Chapter Number*
1	Sept.,	1939	General Introduction and Rules Formerly Adopted..	Introduction and Chap. 1
2	Sept.,	1939	Unamortized Discount and Redemption Premium on Bonds Refunded	15
3	Sept.,	1939	Quasi-Reorganization or Corporate Readjustment—Amplification of Institute Rule No. 2 of 1934......	7(a)
4	Dec.,	1939	Foreign Operations and Foreign Exchange.........	12
5	April,	1940	Depreciation on Appreciation......................	9(b)
6	April,	1940	Comparative Statements	2(a)
7	Nov.,	1940	Reports of Committee on Terminology............	*
8	Feb.,	1941	Combined Statement of Income and Earned Surplus...	2(b)
9	May,	1941	Report of Committee on Terminology.............	*
10	June,	1941	Real and Personal Property Taxes................	10(a)
11	Sept.,	1941	Corporate Accounting for Ordinary Stock Dividends...	7(b)
12	Sept.,	1941	Report of Committee on Terminology.............	*
13	Jan.,	1942	Accounting for Special Reserves Arising Out of the War	**
14	Jan.,	1942	Accounting for United States Treasury Tax Notes..	3(b)
15	Sept.,	1942	The Renegotiation of War Contracts..............	11(b)
16	Oct.,	1942	Report of Committee on Terminology.............	*
17	Dec.,	1942	Post-War Refund of Excess-Profits Tax..........	**
18	Dec.,	1942	Unamortized Discount and Redemption Premium on Bonds Refunded (Supplement)................	15
19	Dec.,	1942	Accounting Under Cost-Plus-Fixed-Fee Contracts..	11(a)
20	Nov.,	1943	Report of Committee on Terminology.............	*
21	Dec.,	1943	Renegotiation of War Contracts (Supplement)....	11(b)
22	May,	1944	Report of Committee on Terminology.............	*
23	Dec.,	1944	Accounting for Income Taxes....................	10(b)
24	Dec.,	1944	Accounting for Intangible Assets.................	5
25	April,	1945	Accounting for Terminated War Contracts........	11(c)
26	Oct.,	1946	Accounting for the Use of Special War Reserves....	**
27	Nov.,	1946	Emergency Facilities	9(c)
28	July,	1947	Accounting Treatment of General Purpose Contingency Reserves	6
29	July,	1947	Inventory Pricing	4
30	Aug.,	1947	Current Assets and Current Liabilities—Working Capital	3(a)
31	Oct.,	1947	Inventory Reserves	6
32	Dec.,	1947	Income and Earned Surplus......................	8
33	Dec.,	1947	Depreciation and High Costs.....................	9(a)
34	Oct.,	1948	Recommendation of Committee on Terminology—Use of Term "Reserve"	*
35	Oct.,	1948	Presentation of Income and Earned Surplus........	8
36	Nov.,	1948	Pension Plans—Accounting for Annuity Costs Based on Past Services..................	13(a)

* Terminology bulletins published separately. ** Withdrawn. See explanation ff. in Appendix C.

No.	Date Issued	Title	Restatement Chapter Number
37	Nov., 1948	Accounting for Compensation in the Form of Stock Options	13(b)
38	Oct., 1949	Disclosure of Long-Term Leases in Financial Statements of Lessees	14
39	Oct., 1949	Recommendation of Subcommittee on Terminology —Discontinuance of the Use of the Term "Surplus"	*
40	Sept., 1950	Business Combinations	7(c)
41	July, 1951	Presentation of Income and Earned Surplus (Supplement to Bulletin No. 35)	8
13 (Addendum)	July, 1951	Limitation of Scope of Special War Reserves	**
26 (Addendum)	July, 1951	Limitation of Scope of Special War Reserves	**
42	Nov., 1952	Emergency Facilities—Depreciation, Amortization, and Income Taxes	9(c)
11 (Revised)	Nov., 1952	Accounting for Stock Dividends and Stock Split-Ups	7(b)
37 (Revised)	Jan., 1953	Accounting for Compensation Involved in Stock Option and Stock Purchase Plans	13(b)

* Terminology bulletins published separately. ** Withdrawn. See explanation ff. in Appendix C.

APPENDIX B Changes of Substance Made in the Course of Restating and Revising the Bulletins

1. Restatement and revision of the Accounting Research Bulletins involved numerous changes in wording, amounting in some cases to complete rewriting, but most of these changes were made in the interest of clarification, condensation, or elimination of material no longer pertinent. Changes in substance where necessary were made and are set forth below by chapters. Particular attention is called to the comments respecting the application of government securities against liabilities for federal taxes on income, write-offs of intangibles, and the treatment of refunds of income taxes based on the carry-back of losses and unused excess-profits credits.

APPLICABILITY OF BULLETINS

2. In Bulletin No. 1 no general comment was made as to the applicability of the committee's pronouncements other than to state that they should not be regarded as applicable to investment trusts. That statement has been omitted. A new statement of applicability appears in the introduction, which indicates that, in general, the committee's opinions should be regarded as applicable primarily to business enterprises organized for profit. The statement reads as follows:

3. "The principal objective of the committee has been to narrow areas of difference and inconsistency in accounting practices, and to further the development and recognition of generally accepted accounting principles, through the issuance of opinions and recommendations that would serve as criteria for determining the suitability of accounting practices reflected in financial statements and representations of commercial and industrial companies. In this endeavor, the committee has considered the interpretation and application of such principles as appeared to it to be pertinent to particular accounting problems. The committee has not directed its attention to accounting problems or procedures of religious, charitable, scientific, educational, and similar non-profit institutions, municipalities, professional firms, and the like. Accordingly, except where there is a specific statement of a different intent by the committee, its opinions and recommendations are directed primarily to business enterprises organized for profit."

CURRENT ASSETS AND CURRENT LIABILITIES

CHAPTER 3, SECTION (a)

4. A comment has been included under current assets to the effect that the description of the basis of pricing inventories should include an indication of the method of determining the cost—e.g., *average cost, first-in first-out, last-in first-out, etc.*

APPLICATION OF UNITED STATES GOVERNMENT SECURITIES AGAINST LIABILITIES FOR FEDERAL TAXES ON INCOME

CHAPTER 3, SECTION (b)

5. In Bulletin No. 14 the committee expressed approval of the offsetting of United States Treasury Tax Notes, Tax Series A-1943 and B-1943, against liabilities for federal taxes on income in the balance sheet, provided that at the date of the balance sheet or of the independent auditor's report there was no evidence of an intent not to surrender the notes in payment of the taxes. Government securities having restrictive terms similar to those contained in the 1943 tax series are no longer issued but certain other types of government securities have since been issued which, by their terms, may be surrendered in payment of liabilities for federal taxes on income. In section (b) of chapter 3 the committee sanctions the offsetting of these securities against liabilities for federal taxes on income. It also expresses the opinion that extension of the practice to include the offset of other types of United States government securities, although a deviation from the general rule against offsets, is not so significant a deviation as to call for an exception in an accountant's report on the financial statements.

INTANGIBLE ASSETS

CHAPTER 5

6. Bulletin No. 24, which was published in 1944, stated the committee's belief that the long accepted practice of eliminating type (b) intangibles (i.e., intangibles with no limited term of existence and as to which there is, at the time of acquisition, no indication of limited life) against any existing surplus, capital or earned, even though the value of the asset was unimpaired, should be discouraged, especially if proposed to be effected by charges to capital surplus.

7. In chapter 5 the committee expresses the opinion that lump-sum write-offs of type (b) intangibles should in no case be charged against capital surplus, should not be made against earned surplus immediately after acquisition, and, if not amortized systematically, should be carried at cost until an event has taken place which indicates a loss or a limitation on the useful life of the intangibles.

CONTINGENCY RESERVES

CHAPTER 6

8. In chapter 6 the opinion is expressed that the preferable balance-sheet treatment of general purpose contingency reserves (a subject not specifically covered in Bulletins Nos. 28 and 31) is to show them under stockholders' equity.

QUASI-REORGANIZATION OR CORPORATE READJUSTMENT

CHAPTER 7, SECTION (a)

9. Bulletin No. 3 stated that a readjustment of accounts through quasi-reorganization calls for the opening of a new earned surplus account dating from the effective date of the readjustment, but made no reference to the length of time such dating should continue. Section (a) of chapter 7 states that ". . . this dating should be disclosed in financial statements until such time as the effective date is no longer deemed to possess any special significance."

BUSINESS COMBINATIONS

CHAPTER 7, SECTION (c)

10. The opinions expressed in Bulletin No. 40 have been amplified to indicate that any adjustment of assets or of surplus which would be in conformity with generally accepted accounting principles in the absence of a combination would be equally acceptable if effected in connection with a pooling of interests.

INCOME TAXES
CHAPTER 10, SECTION (b)

11. In connection with the presentation of allocated income taxes in the income statement, the committee recognizes the possibility of disclosure in a footnote or in the body of the income statement in special cases when the recommended presentation is not considered to be practicable. The revision also contains a statement that in some cases the use of a current over-all effective tax rate or, as in the case of deferred income, an estimated future tax rate may be appropriate in computing the tax effect attributable to a particular transaction.

12. In the old bulletin the committee recommended that where tax reductions result from the carry-forward of losses or unused excess-profits credits, the income statement indicate the results of operations without inclusion of such reduction, which reduction should be shown as a final item before the amount of net income for the period, except that where there is substantial reason to believe that misleading inferences might be drawn from such inclusion the tax reduction might be credited to surplus. Section (b) of chapter 10 adds an alternative treatment whereby the amount of taxes estimated to be actually payable for the year may be shown in the income statement, with the amount of the tax reduction attributable to the amounts carried forward indicated either in a footnote or parenthetically in the body of the income statement.

13. The opinion was expressed in the previous bulletin that claims for refunds of income taxes based on the carry-back of losses or unused excess-profits credits should be credited to income, except that under certain circumstances they might be credited to surplus. Section (b) of chapter 10 expresses the opinion that they should be carried to income. This may be done either by indicating in the income statement for the year the results of operations before application of the claim for refund, which should then be shown as a final item before the amount of net income, or by charging income with the amount of taxes estimated to be actually payable for the year and showing the amount of the reduction attributable to the carry-back in a footnote or parenthetically in the body of the income statement.

RENEGOTIATION OF GOVERNMENT CONTRACTS
CHAPTER 11, SECTION (b)

14. The committee has modified the recommendations made in Bulletin No. 21 respecting the methods to be used in disclosing the renegotiation status and the provision or lack of provision for refund in relation to prior year settlements. It believes that individual judgment should determine which cases require disclosure of the basis of determining the amount provided. The committee has also indicated that the comments in section (b) of chapter 11 are applicable to price redetermination estimated to result in retroactive price reduction.

FOREIGN OPERATIONS AND FOREIGN EXCHANGE
CHAPTER 12

15. In Bulletin No. 4 it was stated that a safe course to follow is to take earnings from foreign operations into the accounts of United States companies only to the extent that funds have been received in the United States. In chapter 12 these words are added: "or unrestricted funds are available for transmission thereto."

16. An exception is noted in chapter 12 to the general rule of translating long-term liabilities and capital stock stated in foreign currency at the rate of exchange prevailing when they were originally incurred or issued. The exception relates to long-term debt incurred or stock issued in connection with the acquisition of fixed assets, permanent investments, or long-term receivables a short time before a substantial and presumably permanent change in the exchange rate. The opinion is expressed that in such instances it may be appropriate to state the long-term debt or the capital stock at the new rate and proper to deal with the exchange differences as an adjustment of the cost of the assets acquired.

17. The revision also takes into consideration the possibility that in some situations more realistic results will be obtained by translating income for the entire fiscal year at the new rates in effect after such major fluctuation. Where dividends have been paid prior to a major change in the ex-

change rate, out of earnings of the current fiscal year, that portion of the income for the year should be considered as having been earned at the rate at which such dividend was paid irrespective of the rates used in translating the remainder of the earnings.

18. Consideration is also given to the matter of devaluation losses arising from world-wide readjustment, as to which the committee comments that where they are so material that their inclusion in the income statement would impair the significance of net income to an extent that misleading inferences might be drawn therefrom, consideration may appropriately be given to charging them to surplus.

19. The three preceding paragraphs relate to changes which, in part, give recognition to recommendations made in a statement entitled *Accounting Problems Arising from Devaluation of Foreign Currencies* issued as a research memorandum in November, 1949.

UNAMORTIZED DISCOUNT, ISSUE COST, AND REDEMPTION PREMIUM ON BONDS REFUNDED

CHAPTER 15

20. When Bulletin No. 2 was issued the committee considered three methods of writing off unamortized discount on refunded bonds (including issue cost and redemption premium):

(a) Write-off by a direct charge to earned surplus in the year of refunding;

(b) Amortization over the remainder of the original life of the issue retired; or

(c) Amortization over the life of the new issue.

21. Methods (a) and (b) were at that time approved as acceptable practice, with a comment that, with a continuance of the shift in emphasis from the balance sheet to the income account, method (b) might well become the preferred procedure. Method (c) was stated to be unacceptable except where such treatment was authorized or prescribed by a regulatory body to whose jurisdiction the accounting corporation was subject, or had been adopted by the company prior to the publication of Bulletin No. 2.

22. In chapter 15 a write-off in full in the year of refunding is stated to be acceptable. The committee believes, however, that the charge should be to income rather than earned surplus, unless the net income figure would thereby be so distorted as to invite misleading inferences. It further believes that any write-off made to earned surplus should be limited to the excess of the unamortized discount over the reduction of current taxes to which the refunding gives rise.

23. Distribution of the charge, by systematic charges against income, over the remainder of the original life of the bonds refunded (method (b)) is stated in chapter 15 to be the preferred method, conforming more closely than any other to current accounting opinion. When this method is adopted an amount equal to the reduction in current income tax resulting from the refunding should be deducted in the income statement, and the remainder should be apportioned over the future period.

24. Amortization over the life of the new issue, unless it is less than the remaining life of the old issue, is stated to be an unacceptable practice.

APPENDIX C

Bulletins Not Included in the Restatement and Revision

1. Accounting research bulletins No. 13, *Accounting for Special Reserves Arising Out of the War,* and No. 26, *Accounting for the Use of Special War Reserves,* are not included in the restatement. Those bulletins were formally withdrawn by the committee in July, 1951, by the issuance of addenda. At that time the committee commented that, "in the light of subsequent developments of accounting procedures, these bulletins should no longer be relied upon as a basis for the establishment and use of reserves."

2. Bulletin No. 17, *Post-War Refund of Excess-Profits Tax,* is withdrawn because it no longer has applicability under present tax laws.

3. Bulletins Nos. 7, 9, 12, 16, 20, 22, 34, and 39, which were issued as recommendations of the committee on terminology, are being published separately.

Accounting Research Bulletin No. 44

DECLINING-BALANCE DEPRECIATION

OCTOBER, 1954

1. The declining-balance method of estimating periodic depreciation has a long history of use in England and in other countries including, to a limited extent, the United States. Interest in this method has been increased by its specific recognition for income-tax purposes in the Internal Revenue Code of 1954.

2. The declining-balance method is one of those which meets the requirements of being "systematic and rational."[1] In those cases where the expected productivity or revenue-earning power of the asset is relatively greater during the earlier years of its life, or where maintenance charges tend to increase during the later years, the declining-balance method may well provide the most satisfactory allocation of cost. The conclusions of this bulletin also apply to other methods, including the "sum-of-the-years-digits" method, which produce substantially similar results.

3. When a change to the declining-balance method is made for general accounting purposes, and depreciation is a significant factor in the determination of net income, the change in method, including the effect thereof, should be disclosed in the year in which the change is made.

4. There may be situations in which the declining-balance method is adopted for tax purposes but other appropriate methods are followed for financial accounting purposes. In such cases it may be that accounting recognition should be given to deferred income taxes. However, the committee is of the opinion that, in the ordinary situation, deferred income taxes need not be recognized in the accounts unless it is reasonably certain that the reduction in taxes during the earlier years of use of the declining-balance method for tax purposes is merely a deferment of income taxes until a relatively few years later, and then only if the amounts are clearly material.

The statement entitled "Declining-balance Depreciation" was adopted by the assenting votes of nineteen members of the committee, of whom one, Mr. Stans, assented with qualification. Mr. Burns dissented.

Mr. Stans does not approve the conclusions in the last sentence of paragraph 4. He believes that the reductions in taxes in the earlier years of use in the situations described clearly represent deferments of payment until later years and that the number of years involved has no bearing on the problem. He believes that well-established accounting principles require that deferred income taxes be recognized in every case in which the amounts involved are significant.

Mr. Burns dissents because he believes that the reductions in taxes in the earlier years of use in all cases would clearly represent deferments of payment until later years and that the number of years involved has no bearing on the problem. He believes that compliance with well-established accounting principles requires that deferred income taxes be recognized in every case in which a significant amount is involved in order to avoid a misstatement of reported net income, and he believes that the bulletin should contain a definite statement to that effect.

NOTES

(See Introduction to Accounting Research Bulletin No. 43.)

1. Accounting Research Bulletins represent the considered opinion of at least two-thirds of the members of the committee on accounting procedure, reached on a formal vote after examination of the subject matter by the committee and the research department. Except in cases in which formal adoption by the Institute membership has been asked and secured, the authority of the bulletins rests upon the general acceptability of opinions so reached.

2. Opinions of the committee are not intended to be retroactive unless they contain a statement of such intention. They should not be considered applicable to the accounting

[1] *Accounting Terminology Bulletin* No. 1, paragraph 56.

for transactions arising prior to the publication of the opinions. However, the committee does not wish to discourage the revision of past accounts in an individual case if the accountant thinks it desirable in the circumstances. Opinions of the committee should be considered as applicable only to items which are material and significant in the relative circumstances.

3. It is recognized also that any general rules may be subject to exception; it is felt, however, that the burden of justifying departure from accepted procedures must be assumed by those who adopt other treatment. Except where there is a specific statement of a different intent by the committee, its opinions and recommendations are directed primarily to business enterprises organized for profit.

Committee on Accounting Procedure (1953-1954)

John A. Lindquist, *Chairman*
Garrett T. Burns
Robert Caldwell, Jr.
Almand R. Coleman
L. T. Flatley
Roy F. Godfrey
Clifford V. Heimbucher
Thomas G. Higgins
William L. Keating
Colin MacLennan
Howard W. Maloy
John K. McClare
John Peoples
Donald P. Perry
John W. Queenan
Maurice H. Stans
J. Harold Stewart
William W. Werntz
Edward B. Wilcox
Robert W. Williams

Carman G. Blough
Director of Research

Accounting Research Bulletin No. 44 (Revised)

DECLINING-BALANCE DEPRECIATION

(Supersedes Accounting Research Bulletin No. 44 Issued in October 1954)

JULY, 1958

1. The declining-balance method of estimating periodic depreciation has a long history of use in England and in other countries including, to a limited extent, the United States. Interest in this method has been increased by its specific recognition for income-tax purposes in the Internal Revenue Code of 1954.

2. The declining-balance method is one of those which meets the requirements of being "systematic and rational."[1] In those cases where the expected productivity or revenue-earning power of the asset is relatively greater during the earlier years of its life, or where maintenance charges tend to increase during the later years, the declining-balance method may well provide the most satisfactory allocation of cost. The conclusions of this bulletin also apply to other methods, including the "sum-of-the-years-digits" method, which produce substantially similar results.

3. When a change to the declining-balance method is made for general accounting purposes, and depreciation is a significant factor in the determination of net income, the change in method, including the effect thereof, should be disclosed in the year in which the change is made.

4. There may be situations in which the declining-balance method is adopted for income-tax purposes but other appropriate methods are used for financial accounting purposes. In such cases, accounting recognition should be given to deferred income taxes if the amounts thereof are material, except in those rare cases, such as are mentioned in paragraph 8, where there are special circumstances which may make such procedure inappropriate. The foregoing provision as to accounting recognition of deferred income taxes applies to a single asset, or to a group of assets which are expected to be retired from service at about the same time; in this case an excess of depreciation taken for income-tax purposes during the earlier years would be followed by the opposite condition in later years, and there would be a tax deferment for a definite period. It applies also to a group of assets consisting of numerous units which may be of differing lengths of life and which are expected to be continually replaced; in this case an excess of depreciation taken for income-tax purposes during the earlier years would be followed in later years by substantial equality between the annual depreciation for income-tax purposes and that for accounting purposes, and a tax deferment would be built up during the earlier years which would tend to remain relatively constant thereafter. It applies further to a gradually expanding plant; in this case an excess of depreciation taken for income-tax purposes may exist each year during the period of expansion in which event there would be a tax deferment which might increase as long as the period of expansion continued.

5. Where it may reasonably be presumed that the accumulative difference between taxable income and financial income will continue for a long or indefinite period, it is alternatively appropriate, instead of crediting a deferred tax account, to recognize the related tax effect as additional amortization or depreciation applicable to such assets in recognition of the loss of future deductibility for income-tax purposes.

DISCUSSION

6. Following the passage of the Internal Revenue Act of 1954 in August of that year, permitting the use of declining-balance and similar accelerated depreciation methods for federal income-tax purposes, the committee anticipated that many companies would be considering whether such methods should be adopted for general accounting purposes. In October of that year, Accounting Research Bulletin No. 44 was issued in which the committee stated that such accelerated methods met the requirement of being "systematic and rational." The committee also stated that when such methods were adopted for general accounting purposes, appropriate disclosure of the change should be made whenever depreciation was a significant factor in the determination of net income.

[1] *Accounting Terminology Bulletin* No. 1, paragraph 56.

7. Since the issuance of Accounting Research Bulletin No. 44, the committee has been observing and studying cases involving the application of the bulletin. Studies of published reports and other source material have indicated that, where material amounts are involved, recognition of deferred income taxes in the general accounts is needed to obtain an equitable matching of costs and revenues and to avoid income distortion, even in those cases in which the payment of taxes is deferred for a relatively long period. This conclusion is borne out by the committee's studies which indicate that where accelerated depreciation methods are used for income-tax purposes only, most companies do give recognition to the resultant deferment of income taxes or, alternatively, recognize the loss of future deductibility for income-tax purposes of the cost of fixed assets by an appropriate credit to an accumulated amortization or depreciation account applicable to such assets.

8. Many regulatory authorities permit recognition of deferred income taxes for accounting and/or rate-making purposes, whereas some do not. The committee believes that they should permit the recognition of deferred income taxes for both purposes. However, where charges for deferred income taxes are not allowed for rate-making purposes, accounting recognition need not be given to the deferment of taxes if it may reasonably be expected that increased future income taxes, resulting from the earlier deduction of declining-balance depreciation for income-tax purposes only, will be allowed in future rate determinations.

9. In those rare situations in which accounting for deferred income taxes is not appropriate, full disclosure should be made of the amount of deferred income taxes arising out of the difference between the financial statements and the tax returns when the declining-balance method is adopted for income-tax purposes but other appropriate methods are used for financial accounting purposes.

10. The committee believes that, in applying the provisions of this bulletin to cases where there was no accounting recognition of deferred income taxes for the years since 1953, the entries made for periods subsequent to the issuance of this bulletin should be based upon all assets acquired after 1953 as to which the declining-balance method has been elected for tax purposes. As is indicated in the "Notes" to each Accounting Research Bulletin, opinions of the committee are not intended to be retroactive unless they contain a statement of such intention. If a retroactive adjustment is made for prior periods, the adjustment may be made in a lump sum, or the deficiency may be systematically accumulated over a reasonable future period of time.

The statement entitled "Declining-balance Depreciation" (July 1958) was adopted unanimously by the twenty-one members of the committee, of whom five, Messrs. Burns, Graham, Halvorson, Jennings, and Powell, assented with qualification.

Mr. Burns objects to the exceptions mentioned in paragraph 4 and discussed in paragraphs 8 and 9. He believes that accounting principles apply equally to all companies operated for profit and that the exceptions referred to are wholly inconsistent with the basic principles stated in paragraph 4; further, that the last sentence of paragraph 8 is based upon an untenable concept, namely, that accounting resulting from the application of an accounting rule prescribed by a regulatory commission may properly be approved by public accountants notwithstanding the fact that the rule is clearly contrary to generally accepted accounting principles.

Mr. Graham objects to the exceptions mentioned in the second sentence of paragraph 4 and discussed in the last sentence of paragraph 8 and in paragraph 9. He believes that accepted accounting principles should be applied uniformly to all corporations, including regulated companies. He does not believe that rate-making rules which are in conflict with these accepted principles constitute a sound basis for sanctioning a departure from these principles in financial reporting. Furthermore, he disagrees with the validity of the assumption which, by implication, forms the basis for this exception; he does not believe that public utility rates will always be adjusted automatically to compensate fully, or even substantially, for increases in future income taxes; he believes that this assumption is not in accord with the known realities of rate regulation and is not, therefore, a proper basis for the anticipation of future revenues.

Mr. Halvorson dissents from the recommendations of paragraph 4 because he believes its requirements for accounting recognition of deferred income taxes should be limited to a requirement for compliance with the recommendations of chapter 10(b) of Accounting Research Bulletin No. 43; he believes that paragraph 4 is effectively a revision of chapter 10(b) and that it is improper thus to make a substantive change in the committee's existing recommendations for tax allocation in the guise of a revision of a bulletin on depreciation.

Messrs. Jennings and Powell dissent from the conclusion (expressed in paragraph 4 and implied in the related discussion) that where the declining-balance method is adopted for income-tax purposes but other appropriate methods are used for financial accounting purposes, there should be accounting recognition of deferred income taxes, except for certain rare cases. They believe this calls for more extensive allocation of income taxes among periods of time than is necessary or desirable, especially where the situation is such that the so-called tax deferment is in effect a permanent tax reduction. Further, they object to the use of a bulletin on depreciation incidentally as a vehicle for making an important change in the committee's views, as set forth in previous bulletins, on accounting for income taxes.

NOTES

(See Introduction to *Accounting Research Bulletin* No. 43.)

1. Accounting Research Bulletins represent the considered opinion of at least two-thirds of the members of the committee on accounting procedure, reached on a formal vote after examination of the subject matter by the committee, the technical services department, and the director of research. Except in cases in which formal adoption by the Institute membership has been asked and secured, the authority of the bulletins rests upon the general acceptability of opinions so reached.

2. Opinions of the committee are not intended to be retroactive unless they contain a statement of such intention. They should not be considered applicable to the accounting for transactions rising prior to the publication of the opinions. However, the committee does not wish to discourage the revision of past accounts in an individual case if the accountant thinks it desirable in the circumstances. Opinions of the committee should be considered as applicable only to items which are material and significant in the relative circumstances.

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Committee on Accounting Procedure (1957-58)

American Institute of Certified Public Accountants

270 MADISON AVENUE, NEW YORK 16, N. Y.

April 15, 1959

To the members of the American Institute of Certified Public Accountants

Gentlemen:

Question has been raised with respect to the intent of the committee on accounting procedure in using the phrase "a deferred tax account" in Accounting Research Bulletin No. 44 (revised), *Declining-balance Depreciation,* to indicate the account to be credited for the amount of the deferred income tax (see paragraphs 4 and 5).

The committee used the phrase in its ordinary connotation of an account to be shown in the balance sheet as a liability or a deferred credit. A provision in recognition of the deferral of income taxes, being required for the proper determination of net income, should not at the same time result in a credit to earned surplus or to any other account included in the stockholders' equity section of the balance sheet.

Three of the twenty-one members of the committee, Messrs. Jennings, Powell and Staub, dissented to the issuance at this time of any letter interpreting Accounting Research Bulletin No. 44 (revised).

COMMITTEE ON ACCOUNTING PROCEDURE

By William W. Werntz, *Chairman*

Accounting Research Bulletin No. 45

LONG-TERM CONSTRUCTION-TYPE CONTRACTS

OCTOBER, 1955

1. This bulletin is directed to the accounting problems in relation to construction-type contracts in the case of commercial organizations engaged wholly or partly in the contracting business. It does not deal with cost-plus-fixed-fee contracts, which are discussed in Chapter 11, Section A, of Accounting Research Bulletin No. 43*, other types of cost-plus-fee contracts, or contracts such as those for products or services customarily billed as shipped or rendered. In general the type of contract here under consideration is for construction of a specific project. While such contracts are generally carried on at the job site, the bulletin would also be applicable in appropriate cases to the manufacturing or building of special items on a contract basis in a contractor's own plant. The problems in accounting for construction-type contracts arise particularly in connection with long-term contracts as compared with those requiring relatively short periods for completion.

2. Considerations other than those acceptable as a basis for the recognition of income frequently enter into the determination of the timing and amounts of interim billings on construction-type contracts. For this reason, income to be recognized on such contracts at the various stages of performance ordinarily should not be measured by interim billings.

GENERALLY ACCEPTED METHODS

3. Two accounting methods commonly followed by contractors are the percentage-of-completion method and the completed-contract method.

Percentage-of-Completion Method

4. The percentage-of-completion method recognizes income as work on a contract progresses. The committee recommends that the recognized income be that percentage of estimated total income, either:

(a) that incurred costs to date bear to estimated total costs after giving effect to estimates of costs to complete based upon most recent information, or

(b) that may be indicated by such other measure of progress toward completion as may be appropriate having due regard to work performed.

Costs as here used might exclude, especially during the early stages of a contract, all or a portion of the cost of such items as materials and subcontracts if it appears that such an exclusion would result in a more meaningful periodic allocation of income.

5. Under this method current assets may include costs and recognized income not yet billed, with respect to certain contracts; and liabilities, in most cases current liabilities, may include billings in excess of costs and recognized income with respect to other contracts.

6. When the current estimate of total contract costs indicates a loss, in most circumstances provision should be made for the loss on the entire contract. If there is a close relationship between profitable and unprofitable contracts, such as in the case of contracts which are parts of the same project, the group may be treated as a unit in determining the necessity for a provision for loss.

7. The principal advantages of the percentage-of-completion method are periodic recognition of income currently rather than irregularly as contracts are completed, and the reflection of the status of the uncompleted contracts provided through the current estimates of costs to complete or of progress toward completion.

8. The principal disadvantage of the percentage-of-completion method is that it is necessarily dependent upon estimates of ultimate costs and consequently of currently accruing income, which are subject to the uncertainties frequently inherent in long-term contracts.

Completed-Contract Method

9. The completed-contract method recognizes income only when the contract is completed, or substantially so. Accordingly, costs of contracts in process and current billings are accumulated but there are no interim charges or credits to income other than provisions for losses. A contract may

* *Restatement and Revision of Accounting Research Bulletins*, American Institute of Accountants, 1953.

be regarded as substantially completed if remaining costs are not significant in amount.

10. When the completed-contract method is used, it may be appropriate to allocate general and administrative expenses to contract costs rather than to periodic income. This may result in a better matching of costs and revenues than would result from treating such expenses as period costs, particularly in years when no contracts were completed. It is not so important, however, when the contractor is engaged in numerous projects and in such circumstances it may be preferable to charge those expenses as incurred to periodic income. In any case there should be no excessive deferring of overhead costs, such as might occur if total overhead were assigned to abnormally few or abnormally small contracts in process.

11. Although the completed-contract method does not permit the recording of any income prior to completion, provision should be made for expected losses in accordance with the well established practice of making provision for foreseeable losses. If there is a close relationship between profitable and unprofitable contracts, such as in the case of contracts which are parts of the same project, the group may be treated as a unit in determining the necessity for a provision for losses.

12. When the completed-contract method is used, an excess of accumulated costs over related billings should be shown in the balance sheet as a current asset, and an excess of accumulated billings over related costs should be shown among the liabilities, in most cases as a current liability. If costs exceed billings on some contracts, and billings exceed costs on others, the contracts should ordinarily be segregated so that the figures on the asset side include only those contracts on which costs exceed billings, and those on the liability side include only those on which billings exceed costs. It is suggested that the asset item be described as "costs of uncompleted contracts in excess of related billings" rather than as "inventory" or "work in process," and that the item on the liability side be described as "billings on uncompleted contracts in excess of related costs."

13. The principal advantage of the completed-contract method is that it is based on results as finally determined, rather than on estimates for unperformed work which may involve unforeseen costs and possible losses.

14. The principal disadvantage of the completed-contract method is that it does not reflect current performance when the period of any contract extends into more than one accounting period and under such circumstances it may result in irregular recognition of income.

Selection of Method

15. The committee believes that in general when estimates of costs to complete and extent of progress toward completion of long-term contracts are reasonably dependable, the percentage-of-completion method is preferable. When lack of dependable estimates or inherent hazards cause forecasts to be doubtful, the completed-contract method is preferable. Disclosure of the method followed should be made.

COMMITMENTS

16. In special cases disclosures of extraordinary commitments may be required, but generally commitments to complete contracts in process are in the ordinary course of a contractor's business and are not required to be disclosed in a statement of financial position. They partake of the nature of a contractor's business, and generally do not represent a prospective drain on his cash resources since they will be financed by current billings.

The statement entitled "Long-term Construction-type Contracts" was adopted unanimously by the twenty-one members of the committee, of whom two, Mr. Coleman and Mr. Dixon, assented with qualification.

Mr. Coleman and Mr. Dixon do not approve the statements in paragraphs 6 and 11 as to provisions for expected losses on contracts. They believe that such provisions should be made in the form of footnote disclosure or as a reservation of retained earnings, rather than by a charge against revenues of the current period.

Mr. Coleman also questions the usefulness of the refinement of segregating the offset costs and billings by character of excess as set forth in the second sentence of paragraph 12. He suggests that a more useful alternative would be to show in any event total costs and total billings on all uncompleted contracts (a) with the excess shown either as a current asset or a current liability, and (b) with a supporting schedule indicating individual contract costs, billings, and explanatory comment.

NOTES

(See Introduction to Accounting Research Bulletin No. 43.)

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3. It is recognized also that any general rules may be subject to exception; it is felt, however, that the burden of justifying departure from accepted procedures must be assumed by those who adopt other treatment. Except where there is a specific statement of a different intent by the committee, its opinions and recommendations are directed primarily to business enterprises organized for profit.

Committee on Accounting Procedure (1954-1955)

John A. Lindquist, *Chairman*
Gordon S. Battelle
Garrett T. Burns
Robert Caldwell, Jr.
Almand R. Coleman
Robert L. Dixon
L. T. Flatley
Thomas D. Flynn
Clifford V. Heimbucher
Harry D. Hopson
Donald R. Jennings
William L. Keating
Colin MacLennan
H. W. Maloy
John K. McClare
John Peoples
Weldon Powell
Walter R. Staub
Ross T. Warner
William W. Werntz
Edward B. Wilcox

Carman G. Blough, *Director of Research*

Accounting Research Bulletin No. 46

DISCONTINUANCE OF DATING EARNED SURPLUS

FEBRUARY, 1956

1. Paragraph 10 of Chapter 7(a), *Quasi-Reorganization or Corporate Readjustment*, of Accounting Research Bulletin No. 43, *Restatement and Revision of Accounting Research Bulletins*, reads as follows:

> After such a readjustment earned surplus previously accumulated cannot properly be carried forward under that title. A new earned surplus account should be established, dated to show that it runs from the effective date of the readjustment, and this dating should be disclosed in financial statements until such time as the effective date is no longer deemed to possess any special significance.

2. The committee believes that the dating of earned surplus following a quasi-reorganization would rarely, if ever, be of significance after a period of ten years. It also believes that there may be exceptional circumstances in which the discontinuance of the dating of earned surplus could be justified at the conclusion of a period less than ten years.

The statement entitled "Discontinuance of Dating Earned Surplus" was adopted by the assenting votes of twenty members of the committee. One member, Mr. Keating, did not vote.

NOTES

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Committee on Accounting Procedure (1955-1956)

John A. Lindquist, *Chairman*
Gordon S. Battelle
Garrett T. Burns
Robert Caldwell
Almand R. Coleman
Robert L. Dixon
L. T. Flatley
Thomas D. Flynn
Carl H. Forsberg
LeVerne W. Garcia
Donald R. Jennings
William L. Keating
Homer L. Luther
John K. McClare
John Peoples
Weldon Powell
Walter R. Staub
Ross T. Warner
William W. Werntz
Edward B. Wilcox
James B. Willing

Carman G. Blough
Director of Research

Accounting Research Bulletin No. 47

ACCOUNTING FOR COSTS OF PENSION PLANS

SEPTEMBER, 1956

1. Variations in the provisions of pension plans in the United States, in their financial arrangements, and in the circumstances attendant upon their adoption, have resulted in substantial differences in accounting for pension costs. This bulletin indicates guides which, in the opinion of the committee, are acceptable for dealing with costs of pension plans in the accounts and reports of companies having such plans. It is not concerned with funding as such.

2. The term *pension plan* is here intended to mean a formal arrangement for employee retirement benefits, whether established unilaterally or through negotiation, by which commitments, specific or implied, have been made which can be used as the basis for estimating costs. It does not include profit-sharing plans or deferred-compensation contracts with individuals. It does not apply to informal arrangements by which voluntary payments are made to retired employees, usually in amounts fixed at or about the time of an employee's retirement and in the light of his then situation but subject to change or discontinuance at the employer's will; where such informal arrangements exist, the pay-as-you-go method of accounting for pension costs generally is appropriate, although the accrual method is equally appropriate in cases where costs can be estimated with reasonable accuracy.

3. When a pension plan is first adopted, it is customary to provide that pensions for covered employees will give recognition not only to services which are to be rendered by them in the future, but also to services which have been rendered by them prior to the adoption of the plan. The costs of the pensions to the employer, therefore, usually are based in part on past services and in part on current and future services of the employees. The committee considers that all of such costs are costs of doing business, incurred in contemplation of present and future benefits, as are other employment costs such as wages, salaries, and social security taxes. It, therefore, is of the opinion that past service benefit costs should be charged to operations during the current and future periods benefited, and should not be charged to earned surplus *at the inception of the plan.* The committee believes that, in the case of an *existing plan* under which inadequate charges or no charges for past services have been made thus far and the company has decided to conform its accounting to the preferred procedure expressed in this bulletin, it may be appropriate to charge to earned surplus the amount that should have been accumulated by charges to income since inception of the plan.

4. In addition to the basic features of a pension plan relating to employee eligibility and the level of pension payments, other factors enter into the determination of the ultimate costs of pensions. Some of these are:

(a) other benefits (such as social security) where amounts of pension payments are integrated therewith;

(b) length of life of employees both before and after retirement;

(c) employee turnover;

(d) in some cases, alternatives as to age at which employees may retire;

(e) future compensation levels; and

(f) in a funded plan, future rates of earnings on the fund and the status of fund investments.

Because of these factors, the total cost of the pensions that will be paid ultimately to the present participants in a plan cannot be determined precisely in advance, but, by the use of actuarial techniques, reasonably accurate estimates can be made. There are other business costs for which it is necessary to make periodic provisions in the accounts based upon assumptions and estimates. The committee believes that the uncertainties relating to the determination of pension costs are not so pronounced as to preclude similar treatment.

5. In the view of many, the accrual of costs under a pension plan should not necessarily be dependent on the funding arrangements provided for in the plan or governed by a strict legal interpretation of the obligations under the plan. They feel that because of the widespread adoption of pension plans and their importance as part of compensation structures, a provision for cancellation or the existence of a terminal date for a plan should not be the controlling factor in accounting for pension costs, and that for accounting purposes it is reasonable to assume in most cases that a plan, though modified or renewed (because of terminal

dates) from time to time, will continue for an indefinite period. According to this view, costs based on current and future services should be systematically accrued during the expected period of active service of the covered employees, generally upon the basis of actuarial calculations. Such calculations may be made as to each employee, or as to categories of employees (by age, length of service, or rate of pay, for example), or they may be based upon an average of the expected service lives of all covered employees. These calculations, although made primarily for funding purposes, may be used also for accounting purposes. They should, of course, be revised at intervals. Also according to this view, costs based on past services should be charged off over some reasonable period, provided the allocation is made on a systematic and rational basis and does not cause distortion of the operating results in any one year. The length of the period benefited by costs based on past services is subject to considerable difference of opinion. Some think that the benefits accrue principally during the early years of a plan; others feel that the period primarily benefited approximates the remaining service life of the employees covered by a plan at the time of its adoption; still others believe that the benefits of such costs extend over an indefinite period, possibly the entire life of a plan and its successors, if any. In practice, costs based on past services have in many instances been charged off over a ten- to twelve-year period, or over a fixed longer period such as twenty or thirty years. (The minimum period presently permitted for tax purposes is ten years if the initial past-service cost is immediately paid in full, or about twelve years if one-tenth of the initial past-service cost plus interest is paid each year.)

6. In the view of others, the full accrual of pension costs may be unnecessary. They point out that in some cases accounting for such costs in the manner indicated in paragraph 5 would result, as to a given year or cumulatively or both, in the accrual of costs under a pension plan in amounts differing materially from the payments made under the plan into a pension fund or to retired employees, and in other cases it would require the employer to record pension costs in amounts varying widely from his legal liabilities. They say that a company would in all probability never be called upon to utilize the entire amount of an actuarially calculated full accrual, and that, in the event of liquidation of the business, any amounts accrued with respect to employees who have not at the time acquired vested rights would, except for a voluntary act of grace, revert to the surplus of the company. They also believe that in the case of an unfunded or partially funded plan the accumulation of a substantial accrual would lead to pressure for full funding, possibly to the detriment of the company and its security holders, and that fear of this might deter management from entering into pension arrangements beneficial to employees. They also feel that the method of accounting envisioned in paragraph 5 disregards the probability that future unfavorable changes in a company's economic position undoubtedly would lead to changes in the pension arrangements it would make for its employees. According to this view, management should have wider discretion in accounting for pension costs, provided there is adequate disclosure as to the method followed.

7. The committee regards the method outlined in paragraph 5 as being the method most likely to effect a reasonable matching of costs and revenues, and therefore considers it to be preferable. However, the committee believes that opinion as to the accounting for pension costs has not yet crystallized sufficiently to make it possible at this time to assure agreement on any one method, and that differences in accounting for pension costs are likely to continue for a time. Accordingly, for the present, the committee believes that, as a minimum, the accounts and financial statements should reflect accruals which equal the present worth, actuarially calculated, of pension commitments to employees to the extent that pension rights have vested in the employees, reduced, in the case of the balance sheet, by any accumulated trusteed funds or annuity contracts purchased.

8. The committee believes that the costs of many pension plans are so material that the fact of adoption of a plan or an important amendment to it constitutes significant information in financial statements. When a plan involving material costs is adopted, there should be a footnote to the financial statements for the year in which this occurs, stating the important features of the plan, the proposed method of funding or paying, the estimated annual charge to operations, and the basis on which such annual charge is determined. When an existing plan is amended to a material extent, there should be similar disclosure of the pertinent features of the amendment.

When there is a change in the accounting procedure which materially affects the results of operations, there should be appropriate indication thereof. If there are costs of material amount based on past or current services for which reasonable provision has not been, or is not being, made in the accounts, appropriate disclosure should be made in a footnote to the financial statements as long as this situation exists.

The statement entitled "Accounting for Costs of Pension Plans" was adopted unanimously by the twenty-one members of the committee, of whom six, Messrs. Flatley, Jennings, Lindquist, Luther, Powell and Staub, assented with qualification.

The six members assenting with qualification object to that part of paragraph 3 which appears to sanction the charging to earned surplus in some circumstances of pension costs based on past service. They believe this to be in conflict with section A of chapter 13 of Accounting Research Bulletin No. 43, in which the committee expresses the opinion that costs of annuities based on past service should not be charged to surplus. They consider the conclusions expressed in chapter 13 to be sound for the reasons therein stated.

NOTES

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Committee on Accounting Procedure (1955-1956)

JOHN A. LINDQUIST, *Chairman*
GORDON S. BATTELLE
GARRETT T. BURNS
ROBERT CALDWELL
ALMAND R. COLEMAN
ROBERT L. DIXON
L. T. FLATLEY
THOMAS D. FLYNN
CARL H. FORSBERG
LEVERNE W. GARCIA
DONALD R. JENNINGS
WILLIAM L. KEATING
HOMER L. LUTHER
JOHN K. MCCLARE
JOHN PEOPLES
WELDON POWELL
WALTER R. STAUB
ROSS T. WARNER
WILLIAM W. WERNTZ
EDWARD B. WILCOX
JAMES B. WILLING

CARMAN G. BLOUGH
Director of Research

Accounting Research Bulletin No. 48

BUSINESS COMBINATIONS

(Supersedes chapter 7(c) of Accounting Research Bulletin No. 43)

JANUARY, 1957

1. Whenever two or more corporations are brought together, or combined, for the purpose of carrying on the previously conducted businesses, the accounting to give effect to the combination will vary depending largely upon whether an important part of the former ownership is eliminated or whether substantially all of it is continued. This bulletin differentiates these two types of combinations, the first of which is designated herein as a *purchase* and the second as a *pooling of interests,* and indicates the nature of the accounting treatment appropriate to each type.

2. For accounting purposes, the distinction between a *purchase* and a *pooling of interests* is to be found in the attendant circumstances rather than in the designation of the transaction according to its legal form (such as a merger, an exchange of shares, a consolidation, or an issuance of stock for assets and businesses), or in the number of corporations which survive or emerge, or in other legal or tax considerations (such as the availability of surplus for dividends).

3. For accounting purposes, a *purchase* may be described as a business combination of two or more corporations in which an important part of the ownership interests in the acquired corporation or corporations is eliminated or in which other factors requisite to a pooling of interests are not present.

4. In contrast, a *pooling of interests* may be described for accounting purposes as a business combination of two or more corporations in which the holders of substantially all of the ownership interests[1] in the constituent corporations become the owners of a single corporation which owns the assets and businesses of the constituent corporations, either directly or through one or more subsidiaries, and in which certain other factors discussed below are present. Such corporation may be one of the constituent corporations or it may be a new corporation. After a pooling of interests, the net assets of all of the constituent corporations will in a large number of cases be held by a single corporation. However, the continuance in existence of one or more of the constituent corporations in a subsidiary relationship to another of the constituents or to a new corporation does not prevent the combination from being a pooling of interests if no significant minority interest remains outstanding, and if there are important tax, legal, or economic reasons for maintaining the subsidiary relationship, such as the preservation of tax advantages, the preservation of franchises or other rights, the preservation of the position of outstanding debt securities, or the difficulty or costliness of transferring contracts, leases, or licenses.

5. In determining the extent to which a new ownership or a continuity of old ownership exists in a particular business combination, consideration should be given to attendant circumstances. When the shares of stock that are received by the several owners of one of the predecessor corporations are not substantially in proportion to their respective interests in such predecessor, a new ownership or purchase of the predecessor is presumed to result. Similarly, if relative voting rights, as between the constituents, are materially altered through the issuance of senior equity or debt securities having limited or no voting rights, a purchase may be indicated. Likewise, a plan or firm intention and understanding to retire a substantial part of the capital stock issued to the owners of one or more of the constituent corporations, or substantial changes in ownership occurring shortly before or planned to occur shortly after the combination, tends to indicate that the combination is a purchase. However, where a constituent corporation has had two or more classes of stock outstanding prior to the origin of the plan of combination, the redemption, retirement, or conversion of a class or classes of stock having senior or preferential rights as to assets and dividends need not prevent the combination from being considered to be a pooling of interests.

6. Other attendant circumstances should also be taken into consideration in determining whether a purchase or a pooling of

[1] As used in this bulletin, the term "ownership interests" refers basically to common stock, although in some cases the term may also include other classes of stock having senior or preferential rights as well as classes whose rights may be restricted in certain respects.

interests is involved. Since the assumption underlying the pooling-of-interests concept is one of continuity of all of the constituents in one business enterprise, abandonment or sale of a large part of the business of one or more of the constituents militates against considering the combination as a pooling of interests. Similarly, the continuity of management or the power to control management is involved. Thus, if the management of one of the constituents is eliminated or its influence upon the over-all management of the enterprise is very small, a purchase may be indicated. Relative size of the constituents may not necessarily be determinative, especially where the smaller corporation contributes desired management personnel; however, where one of the constituent corporations is clearly dominant (for example, where the stockholders of one of the constituent corporations obtain 90% to 95% or more of the voting interest in the combined enterprise), there is a presumption that the transaction is a purchase rather than a pooling of interests.

7. No one of the factors discussed in paragraphs 5 and 6 would necessarily be determinative and any one factor might have varying degrees of significance in different cases. However, their presence or absence would be cumulative in effect. Since the conclusions to be drawn from consideration of these different relevant circumstances may be in conflict or partially so, determination as to whether a particular combination is a purchase or a pooling of interests should be made in the light of all such attendant circumstances.

8. When a combination is deemed to be a purchase, the assets acquired should be recorded on the books of the acquiring corporation at cost, measured in money, or, in the event other consideration is given, at the fair value of such other consideration, or at the fair value of the property acquired, whichever is more clearly evident. This is in accordance with the procedure applicable to accounting for purchases of assets.

9. When a combination is deemed to be a pooling of interests, a new basis of accountability does not arise. The carrying amounts of the assets of the constituent corporations, if stated in conformity with generally accepted accounting principles and appropriately adjusted when deemed necessary to place them on a uniform accounting basis, should be carried forward; and the combined earned surpluses and deficits, if any, of the constituent corporations should be carried forward, except to the extent otherwise required by law or appropriate corporate action. Adjustments of assets or of surplus which would be in conformity with generally accepted accounting principles in the absence of a combination are ordinarily equally appropriate if effected in connection with a pooling of interests; however, the pooling-of-interests concept implies a combining of surpluses and deficits of the constituent corporations, and it would be inappropriate and misleading in connection with a pooling of interests to eliminate the deficit of one constituent against its capital surplus and to carry forward the earned surplus of another constituent.

10. Where one or more of the constituent corporations continues in existence in a subsidiary relationship, and the requirements of a pooling of interests have been met, the combination of earned surpluses in the consolidated balance sheet is proper since a pooling of interests is not an acquisition as that term is used in paragraph 3 of chapter 1(a) of Accounting Research Bulletin No. 43 which states that earned surplus of a subsidiary corporation created prior to acquisition does not form a part of the consolidated earned surplus. Under the pooling-of-interests concept, the new enterprise is regarded as a continuation of all the constituent corporations and this holds true whether it is represented by a single corporation or by a parent corporation and one or more subsidiaries. If, however, prior to the origin of a plan of combination one party to the combination had been acquired by another such party as a subsidiary in circumstances which precluded the transactions from being considered a pooling of interests, the parent's share of the earned surplus of the subsidiary prior to such acquisition should not be included in the earned surplus of the pooled corporations.

11. Because of the variety of conditions under which a pooling of interests may be carried out, it is not practicable to deal with the accounting presentation except in general terms. A number of problems will arise. For example, if a single corporation survives in a pooling of interests, the stated capital of such corporation may be either more or less than the total of the stated capitals of the constituent corporations. In the former event, the excess may be deducted first from the total of any other contributed capital (capital surplus), and next from the total of any earned surplus, of the constituent corporations. When the stated capital of the surviving corporation is less than the combined stated capitals of the

constituent corporations, the difference should appear in the balance sheet of the surviving corporation as other contributed capital (capital surplus), analogous to that created by a reduction in stated capital where no combination is involved.

12. When a combination is considered to be a pooling of interests, statements of operations issued by the continuing business for the period in which the combination occurs should ordinarily include the combined results of operations of the constituent interests for the part of the period preceding the date on which the combination was effected; if combined statements are not furnished, statements for the constituent corporations prior to the date of combination should be furnished separately or in appropriate groups. Results of operations of the several constituents during periods prior to that in which the combination was effected, when presented for comparative purposes, may be stated on a combined basis, or shown separately where, under the circumstances of the case, that presentation is more useful and informative. Disclosure that a business combination has been, or in the case of a proposed combination will be, treated as a pooling of interests should be made and any combined statements clearly described as such.

The statement entitled "Business Combinations" was unanimously adopted by the twenty-one members of the committee.

NOTES

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3. It is recognized also that any general rules may be subject to exception; it is felt, however, that the burden of justifying departure from accepted procedures must be assumed by those who adopt other treatment. Except where there is a specific statement of a different intent by the committee, its opinions and recommendations are directed primarily to business enterprises organized for profit.

Committee on Accounting Procedure (1956-57)

William W. Werntz, *Chairman*
Gordon S. Battelle
Garrett T. Burns
Dixon Fagerberg, Jr.
L. T. Flatley
Thomas D. Flynn
Carl H. Forsberg
LeVerne W. Garcia
Willard J. Graham
Newman T. Halvorson
Donald R. Jennings
Homer L. Luther
John K. McClare
Herbert E. Miller
John Peoples
Weldon Powell
Walter R. Staub
William J. von Minden
Ross T. Warner
Edward B. Wilcox
James B. Willing

Carman G. Blough, *Director of Research*

Accounting Research Bulletin No. 49

EARNINGS PER SHARE

APRIL, 1958

1. Statistical presentations of periodic net income (or loss) in terms of earnings per share[1] are commonly used in prospectuses, proxy material, and annual reports to shareholders, and in the compilation of business earnings statistics for the press, statistical services, and other publications. This bulletin deals with a number of problems arising in the computation and presentation of such statistics.

2. The committee has previously considered certain aspects of this matter[2] and now reaffirms its earlier conclusions that:

(a) It is, in many cases, undesirable to give major prominence to a single figure of earnings per share;

(b) Any computation of earnings per share for a given period should be related to the amount designated in the income statement as net income for such period; and

(c) Where material extraordinary charges or credits have been excluded from the determination of net income, the per-share amount of such charges and credits should be reported separately and simultaneously.

3. Not only does the use of a single figure for earnings per share involve the same limitations of usefulness as does a single figure for net earnings, but also, in many circumstances, the computation of earnings per share involves unique problems. While it is desirable to achieve as much uniformity as is feasible, clear explanation and disclosure of methods used are especially important in this area of financial reporting.

4. The committee suggests the following general guides to be used in computing and presenting earnings per share:

(a) Where used without qualification, the term *earnings per share* should be used to designate the amount applicable to each share of common stock or other residual security outstanding.

(b) Earnings per share, and particularly comparative statistics covering a period of years, should generally be stated in terms of the common stock position as it existed in the years to which the statistics relate, unless it is clear that the growth or decline of earnings will be more fairly presented, as for example, in the case of a stock split, by dividing prior years' earnings by the current equivalent of the number of shares then outstanding.

(c) *In all cases in which there have been significant changes in stock during the period to which the computations relate, an appropriate explanation of the method used should accompany the presentation of earnings per share.*

SINGLE-YEAR COMPUTATIONS

5. In the computation of earnings per share for a single year, minor increases or decreases in the number of shares outstanding during the year may be disregarded, and it is appropriate to base the computation on the number of shares outstanding at the end of the year. In the case of a substantial increase or decrease in the number of shares resulting from the issuance or reacquisition of stock for cash or other property during the year, it is generally appropriate to base the computation of earnings per share on a weighted average of the number of shares outstanding during the year. Where there has been little or no opportunity to utilize the proceeds from the issuance of such shares, as would most clearly be the case when the shares were issued shortly before the end of the year, such shares may be disregarded in the computation. When an increase in the number of shares outstanding results from a stock dividend or a stock split, or a reduction in the number of shares outstanding results from a reverse split, without proceeds or disbursements, the computation

[1] As used herein, the term *earnings per share* connotes either earnings or losses per share.

[2] Accounting Research Bulletin No. 43, *Restatement and Revision of Accounting Research Bulletins* (1953), Chapter 8, par. 14. Also see Chapter 2(b), par. 4.

should be based on the number of shares outstanding at the end of the year. For purposes of determining the number of shares outstanding, reacquired shares should be excluded.

6. If there has been a stock split[3] or a reverse split after the balance-sheet date but before the issuance of the financial report, it is desirable to base the computation of earnings per share on the new number of shares, since the reader's primary interest is presumed to be in the present stock position. Similar considerations may apply to stock dividends,[3] although a relatively small stock dividend may properly be disregarded. In these cases of changes after the balance-sheet date, it is preferable to choose the more useful and informative basis of computation rather than to present two simultaneous and possibly confusing computations on different bases. When computations of earnings per share reflect changes in the number of shares after the balance-sheet date, it is important that this fact be clearly disclosed since there may be a presumption that earnings per share are based on the number of shares shown on the balance sheet. It is equally important that significant changes in the number of shares after the balance-sheet date be disclosed when such changes are not reflected in the computation of earnings per share.

7. Where there are shares outstanding senior to the common stock or other residual security, the claims of such securities on net income should be deducted from net income or added to net loss before computing per-share figures, since the term *earnings per share* is ordinarily used to designate the amount applicable to each share of common stock or other residual security outstanding. In arriving at net income applicable to common stock for purposes of the per-share computations, provision should be made for cumulative preferred dividends for the year, whether or not earned. In the case of a net loss, the amount of the loss should be increased by any cumulative preferred stock dividends for the year. Where such dividends are cumulative only if earned, no adjustment of this nature is required except to the extent of income available therefor. In all cases the effect that has been given to dividend rights of senior securities in arriving at the earnings per share of common stock should be disclosed.

8. The following special considerations relate to convertible securities:

(a) When debt capital, preferred stock, or other security has been converted into common stock during the year, earnings per share should ordinarily be based on a weighted average of the number of shares outstanding during the year. When the weighted average is used in such cases, adjustments for the year in respect of interest or other related factors are not made.

(b) When capitalizations consist essentially of two classes of common stock, one of which is convertible into the other and is limited in its dividend rights until conversion takes place as, for example, when certain levels of earnings are achieved, two earnings-per-share figures, one assuming conversion, are ordinarily necessary for full disclosure of the situation.

COMPARATIVE STATISTICS

9. Presentations of earnings-per-share data for a period of several years should be governed basically by the criteria for single year presentations, but may involve a number of special considerations in view of changes in conditions during the period, and the purpose for which the data are to be used. It should be recognized that any tabulation of earnings per share for a period of years may have little bearing on the present position, and may fail to give any indication of present expectations. Variations in the capital structure may have substantial effects on earnings per share. The usefulness of such statistics depends in large measure on collateral historical information and disclosure of methods of computation used. The committee's recommendations which follow are intended as guides to general uniformity but not as substitutes for explanations and disclosures or as cures for the inherent defects in statistical presentations of earnings per share.

10. When computations of earnings per share for a period of years, such as are submitted in annual reports and in prospectuses, include periods in which there have been stock splits or reverse splits, the earn-

[3] See Accounting Research Bulletin No. 43, Chapter 7(b).

ings for periods prior to the dates of the splits should be divided by the current equivalent of the number of shares outstanding in the respective prior periods in order to arrive at earnings per share in terms of the present stock position. Similar treatment should be accorded to stock dividends; however, it is permissible not to extend such treatment to small recurrent stock dividends, although in a prospectus or when such dividends in the aggregate become material, consideration should be given to recognizing the cumulative effect thereof. On the other hand, where, during the period of years for which data are given, there have been issuances or reacquisitions of stock for cash or other property, or, issuances in connection with conversions of debt capital, preferred stock, or other security, the computations of earnings per share for the years prior to such changes are not affected; it follows that earnings per share for these years should be based on the number of shares outstanding in the various years. When both situations have occurred, the effect of each should be reflected in accordance with the foregoing recommendations.

11. When equity securities are being publicly offered:

(a) If there have been significant conversions of debt capital, preferred stock, or other security during the period of years for which data are given, it is appropriate to present supplementary calculations revising past figures to reflect subsequent conversions, on a pro forma basis.

(b) If the securities being offered, or their proceeds, are to be used to retire outstanding securities in circumstances which assure such retirement, it may be useful to present, in addition to otherwise appropriate calculations, supplementary computations to show pro forma earnings per share for at least the most recent year as if such substitution of securities had been made. When this is done, the basis of the supplementary computations should be clearly disclosed. Where, however, the securities being offered, or their proceeds, are to be used, not to retire existing securities, but for such purposes as expansion of the business, earnings per share should be computed without adjustment for any increase in the number of shares anticipated as a result of such offering.

12. Where there has been a pooling of interests[4] during the period of years for which data are given, in connection with which the number of shares outstanding or the capital structure in other respects has been changed, the method used in computing earnings per share for those years prior to the pooling of interests should be based on the new capital structure. When there is to be a pooling of interests in connection with which the number of shares outstanding or the capital structure in other respects will be changed, earnings per share for any period for which income statements of the constituent companies are presented in combined form should be computed on a basis consistent with the exchange ratio to be used in the pooling of interests. In either case earnings per share should, in all other respects, be computed in conformity with the principles set forth in the foregoing paragraphs.

EARNINGS COVERAGE OF SENIOR SECURITIES

13. Where periodic net income is related to outstanding shares of senior securities, such as preferred stock, the committee believes that, under most circumstances, the term *earnings per share* is not properly applicable in view of the limited dividend rights of such senior securities. In such cases it may be helpful to show the number of times or the extent to which the requirements of senior dividends have been earned, but such information should not be designated as earnings per share.

MISCELLANEOUS

14. It is impracticable to deal, in this bulletin, with all of the possible conditions and circumstances under which it may be necessary or desirable to compute data in terms of earnings per share—for example, acquisitions, mergers, reorganizations, convertible and participating securities, outstanding stock options, retirements, and various combinations of these circumstances. While such situations should be dealt with

[4] See Accounting Research Bulletin No. 48, *Business Combinations* (1957).

in harmony with the recommendations made in this bulletin, they call for especially careful consideration of facts and the exercise of judgment in the light of all the circumstances of the case and the purposes for which the data are prepared. In such complex situations as those mentioned in this paragraph, a clear disclosure of the basis on which the computations have been made is essential.

DIVIDENDS PER SHARE

15. Although this bulletin deals primarily with earnings per share, certain considerations may apply comparably to dividends per share. In general, dividends per share constitute historical facts and should be so reported. However, in certain cases, such as a stock split as mentioned in paragraph 10, a presentation of dividends per share in terms of the current equivalent of the number of shares outstanding at the time of the dividend is necessary so that dividends per share and earnings per share will be stated on the same basis. When dividends per share are stated on any other than the historical basis, it is generally desirable that such statement be supplemental to the historical record, and its basis and significance should be fully explained.

The statement entitled "Earnings per Share" was unanimously adopted by the twenty-one members of the committee.

NOTES

(See Introduction to *Accounting Research Bulletin No. 43.*)

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Committee on Accounting Procedure (1957-58)

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Accounting Research Bulletin No. 50

CONTINGENCIES

OCTOBER, 1958

1. In the preparation of financial statements presenting financial position or operating results, or both, it is necessary to give consideration to contingencies. In accounting a contingency is an existing condition, situation or set of circumstances, involving a considerable degree of uncertainty, which may, through a related future event, result in the acquisition or loss of an asset, or the incurrence or avoidance of a liability, usually with the concurrence of a gain or loss. A commitment which is not dependent upon some significant intervening factor or decision should not be described as a contingency.

DISCUSSION

2. The contingencies with which this bulletin is primarily concerned are those in which the outcome is not sufficiently predictable to permit recording in the accounts, but in which there is a reasonable possibility of an outcome which might materially affect financial position or results of operations. Examples of contingencies which may result in the incurrence of liabilities, or in losses, are pending or threatened litigation, assessments or possible assessments of additional taxes, or other claims such as renegotiation refunds, that are being or would be contested, guarantees of indebtedness of others, and agreements to repurchase receivables which have been sold. Examples of contingencies which may result in the acquisition of assets, or in gains, are claims against others for patent infringement, price redetermination upward and claims for reimbursement under condemnation proceedings. Material contingencies of the types discussed in this paragraph should be disclosed.

3. Other contingencies may exist where the outcome is reasonably foreseeable, such as probable tax assessments which will not be contested, or anticipated losses from uncollectible receivables. Contingencies of this type which are expected to result in losses should be reflected in the accounts. However, contingencies which might result in gains usually are not reflected in the accounts since to do so might be to recognize revenue prior to its realization,[1] but there should be adequate disclosure.

4. There are also general risk contingencies that are inherent in business operations and which affect many if not all companies, such as the possibility of war, strike, losses from catastrophes not ordinarily insured against, or a business recession. Contingencies of this type need not be reflected in financial statements either by incorporation in the accounts or by other disclosure.[2]

DISCLOSURE

5. Disclosure of contingencies referred to in paragraph 2 should be made in financial statements or in notes thereto. The disclosure should be based as to its extent on judgment in the light of the specific circumstances and should indicate the nature of the contingency, and should give an appraisal of the outlook. If a monetary estimate of the amount involved is not feasible, disclosure should be made in general terms describing the contingency and explaining that no estimated amount is determinable. When amounts are not otherwise determinable, it may be appropriate to indicate the opinion of management or counsel as to the amount which may be involved. In some cases, such as a law suit involving a substantial amount, management may reasonably expect to settle the matter without incurrence of any significant liability; however, consideration should be given to disclosing the existence of the litigation and the opinion of management or counsel with respect thereto. Although disclosures discussed here should be made with respect to those contingencies which may result in material gains or assets as well as with respect to those which may result in material losses or liabilities, care should be exercised in the case of gains or assets to avoid misleading implications as to the likelihood of realization. The discussion in this bulletin does not deal with the question as to whether the existence of any of the contingencies discussed above is such as to require a qualified opinion or a disclaimer of an opinion by the independent certified public accountant.

6. Certain other situations requiring disclosures have sometimes inappropriately been described as though they were contingencies,

[1] See Chapter 1, Accounting Research Bulletin No. 43, *Restatement and Revision of Accounting Research Bulletins.*

[2] For the committee's position with respect to contingency reserves, see Chapter 6 of Accounting Research Bulletin No. 43.

even though they are of a nature not possessing the degree of uncertainty usually associated with the concept of a contingency. Examples are unused letters of credit, long-term leases, assets pledged as security for loans, pension plans, the existence of cumulative preferred stock dividends in arrears, and commitments such as those for plant acquisition or an obligation to reduce debts, maintain working capital, or restrict dividends. While some of these situations may develop into contingencies, they should not be described as contingencies prior to such eventuality.

The statement entitled "Contingencies" was adopted unanimously by the twenty-one members of the committee, of whom two, Messrs. Bedford and Halvorson, assented with qualification.

Mr. Bedford objects to the provision in paragraph 3 that anticipated losses due to a contingency should be recognized in an accounting period prior to the actual incurrence of the loss. He believes that such deductions from revenue, in order to match adequately costs and revenues, should be based upon sufficient statistical evidence or experience to justify an accounting treatment different from that afforded gains. Without the sufficient statistical evidence or experience and without evidence to indicate a loss has been incurred, he believes a contingent loss should be disclosed in such a manner as not to require the recognition of the loss until the loss has been incurred.

Mr. Halvorson believes the bulletin fails in the essential matter of definition in the second sentence of paragraph 1. He feels that "a considerable degree of uncertainty" is beside the point, and that the definition as it stands would not exclude many types of commitments. He believes that the point should be that the "existing condition" and the "related future event" would affect present financial position or present or past operations, and would be so recorded in the statements, if all the uncertainties could be resolved at the time the statements are being issued. He also believes that the bulletin should not deal with the "general risk" contingencies described in paragraph 4, as they are not of a peculiarly accounting nature, and the attempt to accommodate them in an accounting bulletin has required a definition that is so broad as to fail in its purpose.

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Carman G. Blough
Director of Research

Accounting Research Bulletin No. 51

CONSOLIDATED FINANCIAL STATEMENTS

AUGUST, 1959

PURPOSE OF CONSOLIDATED STATEMENTS

1. The purpose of consolidated statements is to present, primarily for the benefit of the shareholders and creditors of the parent company, the results of operations and the financial position of a parent company and its subsidiaries essentially as if the group were a single company with one or more branches or divisions. There is a presumption that consolidated statements are more meaningful than separate statements and that they are usually necessary for a fair presentation when one of the companies in the group directly or indirectly has a controlling financial interest in the other companies.

CONSOLIDATION POLICY

2. The usual condition for a controlling financial interest is ownership of a majority voting interest, and, therefore, as a general rule ownership by one company, directly or indirectly, of over fifty per cent of the outstanding voting shares of another company is a condition pointing toward consolidation. However, there are exceptions to this general rule. For example, a subsidiary should not be consolidated where control is likely to be temporary, or where it does not rest with the majority owners (as, for instance, where the subsidiary is in legal reorganization or in bankruptcy). There may also be situations where the minority interest in the subsidiary is so large, in relation to the equity of the shareholders of the parent in the consolidated net assets, that the presentation of separate financial statements for the two companies would be more meaningful and useful. However, the fact that the subsidiary has a relatively large indebtedness to bondholders or others is not in itself a valid argument for exclusion of the subsidiary from consolidation. (Also, see Chapter 12 of Accounting Research Bulletin No. 43 for the treatment of foreign subsidiaries.)

3. In deciding upon consolidation policy, the aim should be to make the financial presentation which is most meaningful in the circumstances. The reader should be given information which is suitable to his needs, but he should not be burdened with unnecessary detail. Thus, even though a group of companies is heterogeneous in character, it may be better to make a full consolidation than to present a large number of separate statements. On the other hand, separate statements or combined statements would be preferable for a subsidiary or group of subsidiaries if the presentation of financial information concerning the particular activities of such subsidiaries would be more informative to shareholders and creditors of the parent company than would the inclusion of such subsidiaries in the consolidation. For example, separate statements may be required for a subsidiary which is a bank or an insurance company and may be preferable for a finance company where the parent and the other subsidiaries are engaged in manufacturing operations.

4. A difference in fiscal periods of a parent and a subsidiary does not of itself justify the exclusion of the subsidiary from consolidation. It ordinarily is feasible for the subsidiary to prepare, for consolidation purposes, statements for a period which corresponds with or closely approaches the fiscal period of the parent. However, where the difference is not more than about three months, it usually is acceptable to use, for consolidation purposes, the subsidiary's statements for its fiscal period; when this is done, recognition should be given by disclosure or otherwise to the effect of intervening events which materially affect the financial position or results of operations.

5. Consolidated statements should disclose the consolidation policy which is being followed. In most cases this can be made apparent by the headings or other information in the statements, but in other cases a footnote is required.

CONSOLIDATION PROCEDURE GENERALLY

6. In the preparation of consolidated statements, intercompany balances and transactions should be eliminated. This includes intercompany open account balances, security holdings, sales and purchases, interest, dividends, etc. As consolidated statements are based on the assumption that they represent the financial position and operating results

of a single business enterprise, such statements should not include gain or loss on transactions among the companies in the group. Accordingly, any intercompany profit or loss on assets remaining within the group should be eliminated; the concept usually applied for this purpose is gross profit or loss. (See also paragraph 17.) However, in a regulated industry where a parent or subsidiary manufactures or constructs facilities for other companies in the consolidated group, the foregoing is not intended to require the elimination of intercompany profit to the extent that such profit is substantially equivalent to a reasonable return on investment ordinarily capitalized in accordance with the established practice of the industry.

ELIMINATION OF INTERCOMPANY INVESTMENTS

7. Where the cost to the parent of the investment in a purchased[1] subsidiary exceeds the parent's equity in the subsidiary's net assets at the date of acquisition, as shown by the books of the subsidiary, the excess should be dealt with in the consolidated balance sheet according to its nature. In determining the difference, provision should be made for specific costs or losses which are expected to be incurred in the integration of the operations of the subsidiary with those of the parent, or otherwise as a result of the acquisition, if the amount thereof can be reasonably determined. To the extent that the difference is considered to be attributable to tangible assets and specific intangible assets, such as patents, it should be allocated to them. Any difference which cannot be so applied should be shown among the assets in the consolidated balance sheet under one or more appropriately descriptive captions. When the difference is allocated to depreciable or amortizable assets, depreciation and amortization policies should be such as to absorb the excess over the remaining life of related assets. For subsequent treatment of intangibles, see Chapter 5 of Accounting Research Bulletin No. 43.

8. In general, parallel procedures should be followed in the reverse type of case. Where the cost to the parent is less than its equity in the net assets of the purchased subsidiary, as shown by the books of the subsidiary at the date of acquisition, the amount at which such net assets are carried in the consolidated statements should not exceed the parent's cost. Accordingly, to the extent that the difference, determined as indicated in paragraph 7, is considered to be attributable to specific assets, it should be allocated to them, with corresponding adjustments of the depreciation or amortization. In unusual circumstances there may be a remaining difference which it would be acceptable to show in a credit account, which ordinarily would be taken into income in future periods on a reasonable and systematic basis. A procedure sometimes followed in the past was to credit capital surplus with the amount of the excess; such a procedure is not now considered acceptable.

9. The earned surplus or deficit of a purchased[1] subsidiary at the date of acquisition by the parent should not be included in consolidated earned surplus.

10. When one company purchases two or more blocks of stock of another company at various dates and eventually obtains control of the other company, the date of acquisition (for the purpose of preparing consolidated statements) depends on the circumstances. If two or more purchases are made over a period of time, the earned surplus of the subsidiary at acquisition should generally be determined on a step-by-step basis; however, if small purchases are made over a period of time and then a purchase is made which results in control, the date of the latest purchase, as a matter of convenience, may be considered as the date of acquisition. Thus there would generally be included in consolidated income for the year in which control is obtained the postacquisition income for that year, and in consolidated earned surplus the postacquisition income of prior years, attributable to each block previously acquired. For example, if a 45% interest was acquired on October 1, 1957 and a further 30% interest was acquired on April 1, 1958, it would be appropriate to include in consolidated income for the year ended December 31, 1958, 45% of the earnings of the subsidiary for the three months ended March 31, and 75% of the earnings for the nine months ended December 31, and to credit consolidated earned surplus in 1958 with 45% of the undistributed earnings of the subsidiary for the three months ended December 31, 1957.

11. When a subsidiary is purchased during the year, there are alternative ways of

[1] See Accounting Research Bulletin No. 48, *Business Combinations*, for the difference in treatment between a purchase and a pooling of interests.

dealing with the results of its operations in the consolidated income statement. One method, which usually is preferable, especially where there are several dates of acquisition of blocks of shares, is to include the subsidiary in the consolidation as though it had been acquired at the beginning of the year, and to deduct at the bottom of the consolidated income statement the preacquisition earnings applicable to each block of stock. This method presents results which are more indicative of the current status of the group, and facilitates future comparison with subsequent years. Another method of prorating income is to include in the consolidated statement only the subsidiary's revenue and expenses subsequent to the date of acquisition.

12. Where the investment in a subsidiary is disposed of during the year, it may be preferable to omit the details of operations of the subsidiary from the consolidated income statement, and to show the equity of the parent in the earnings of the subsidiary prior to disposal as a separate item in the statement.

13. Shares of the parent held by a subsidiary should not be treated as outstanding stock in the consolidated balance sheet.

MINORITY INTERESTS

14. The amount of intercompany profit or loss to be eliminated in accordance with paragraph 6 is not affected by the existence of a minority interest. The complete elimination of the intercompany profit or loss is consistent with the underlying assumption that consolidated statements represent the financial position and operating results of a single business enterprise. The elimination of the intercompany profit or loss may be allocated proportionately between the majority and minority interests.

15. In the unusual case in which losses applicable to the minority interest in a subsidiary exceed the minority interest in the equity capital of the subsidiary, such excess and any further losses applicable to the minority interest should be charged against the majority interest, as there is no obligation of the minority interest to make good such losses. However, if future earnings do materialize, the majority interest should be credited to the extent of such losses previously absorbed.

INCOME TAXES

16. When separate income tax returns are filed, income taxes usually are incurred when earnings of subsidiaries are transferred to the parent. Where it is reasonable to assume that a part or all of the undistributed earnings of a subsidiary will be transferred to the parent in a taxable distribution, provision for related income taxes should be made on an estimated basis at the time the earnings are included in consolidated income, unless these taxes are immaterial in amount when effect is given, for example, to dividend-received deductions or foreign-tax credits. There is no need to provide for income tax to the parent company in cases where the income has been, or there is evidence that it will be, permanently invested by the subsidiaries, or where the only likely distribution would be in the form of a tax-free liquidation.

17. If income taxes have been paid on intercompany profits on assets remaining within the group, such taxes should be deferred or the intercompany profits to be eliminated in consolidation should be appropriately reduced.

STOCK DIVIDENDS OF SUBSIDIARIES

18. Occasionally, subsidiary companies capitalize earned surplus arising since acquisition, by means of a stock dividend or otherwise. This does not require a transfer to capital surplus on consolidation, inasmuch as the retained earnings in the consolidated financial statements should reflect the accumulated earnings of the consolidated group not distributed to the shareholders of, or capitalized by, the parent company.

UNCONSOLIDATED SUBSIDIARIES IN CONSOLIDATED STATEMENTS

19. There are two methods of dealing with unconsolidated subsidiaries in consolidated statements. Whichever method is adopted should be used for all unconsolidated subsidiaries, subject to appropriate modification in special circumstances. The preferable method, in the view of the committee, is to adjust the investment through income currently to take up the share of the controlling company or companies in the subsidiaries' net income or net loss, except where the subsidiary was excluded because of exchange restrictions or other reasons which raise the question of whether the increase in equity

has accrued to the credit of the group. (Adjustments of the investment would also be made for "special" debits or credits shown on the income statements of the unconsolidated subsidiaries below the net income for the period, and for similar items shown in the schedule of earned surplus.) The other method, more commonly used at present, is to carry the investment at cost, and to take up income as dividends are received; however, provision should be made for any material impairment of the investment, such as through losses sustained by the subsidiaries, unless it is deemed to be temporary. When the latter method is followed, the consolidated statements should disclose, by footnote or otherwise, the cost of the investment in the unconsolidated subsidiaries, the equity of the consolidated group of companies in their net assets, the dividends received from them in the current period, and the equity of the consolidated group in their earnings for the period; this information may be given in total or by individual subsidiaries or groups of subsidiaries.

20. Whichever method of dealing with unconsolidated subsidiaries is followed, if there is a difference between the cost of the investment and the equity in net assets at the date of acquisition, appropriate recognition should be given to the possibility that, had the subsidiaries been consolidated, part of such difference would have been reflected in adjusted depreciation or amortization. Also, appropriate recognition should be given to the necessity for an adjustment for intercompany gains or losses on transactions with unconsolidated subsidiaries. If sales are made to unconsolidated subsidiaries and the investment in the subsidiaries is carried at cost plus the equity in undistributed earnings, an elimination of unrealized intercompany gains and losses should be made to the same extent as if the subsidiaries were consolidated. The same applies where intercompany sales are made by the unconsolidated subsidiaries. If, however, the investment is carried at cost, it is not necessary to eliminate the intercompany gain on sales to such subsidiaries, if the gain on the sales does not exceed the unrecorded equity in undistributed earnings of the unconsolidated subsidiaries. If such gain is material, it should be appropriately disclosed. Where the sales are made by the unconsolidated subsidiaries to companies included in the consolidated group, the intercompany gains or losses should be eliminated in arriving at the amount of the equity in the undistributed earnings of the unconsolidated subsidiaries which will be disclosed in a footnote or otherwise. (See paragraph 19.)

21. Where the unconsolidated subsidiaries are, in the aggregate, material in relation to the consolidated financial position or operating results, summarized information as to their assets, liabilities and operating results should be given in the footnotes or separate statements should be presented for such subsidiaries, either individually or in groups, as appropriate.

COMBINED STATEMENTS

22. To justify the preparation of consolidated statements, the controlling financial interest should rest directly or indirectly in one of the companies included in the consolidation. There are circumstances, however, where combined financial statements (as distinguished from consolidated statements) of commonly controlled companies are likely to be more meaningful than their separate statements. For example, combined financial statements would be useful where one individual owns a controlling interest in several corporations which are related in their operations. Combined statements would also be used to present the financial position and the result of operations of a group of unconsolidated subsidiaries. They might also be used to combine the financial statements of companies under common management.

23. Where combined statements are prepared for a group of related companies, such as a group of unconsolidated subsidiaries or a group of commonly controlled companies, intercompany transactions and profits or losses should be eliminated, and if there are problems in connection with such matters as minority interests, foreign operations, different fiscal periods, or income taxes, they should be treated in the same manner as in consolidated statements.

PARENT-COMPANY STATEMENTS

24. In some cases parent-company statements may be needed, in addition to consolidated statements, to indicate adequately the position of bondholders and other creditors or preferred stockholders of the parent. Consolidating statements, in which one column is used for the parent company and other columns for particular subsidiaries or groups of subsidiaries, often are an effective means of presenting the pertinent information.

The statement entitled "Consolidated Financial Statements" was unanimously adopted by the twenty-one members of the committee, of whom nine, Messrs. Bedford, Dunn, Graese, Graham, Halvorson, Hoyler, Kent, Powell, and Werntz, assented with qualification.

Mr. Bedford objects to the provision in paragraph 2 that ownership of over fifty per cent of the outstanding voting stock is the general rule governing consolidation policy. He believes the over fifty per cent ownership requirement is at best only one of several criteria evidencing the existence of a consolidated entity.

Messrs. Graese and Hoyler do not agree with the statement made in the last sentence of paragraph 8. Mr. Graese believes there are cases in which the crediting of a capital surplus account with the "excess credit" will result in a more appropriate presentation of consolidated operations and financial position, particularly in (but not limited to) situations where the acquisition of control of the subsidiary has been accomplished over an extended period of time or where there are acquisitions of minority interest at a date considerably after obtaining control. Mr. Hoyler is of the opinion that there have been, and probably will be, circumstances under which credits to capital surplus of the excesses referred to in this paragraph will be appropriate.

Messrs. Halvorson and Werntz object to the relative emphasis given to the recommendations in paragraph 10, which they believe should be reversed. They believe that the date of the purchase which results in control should generally be considered to be the date of acquisition; however, if a limited number of purchases are made over a period of time pursuant to a plan or program which culminates in control, they agree that the earned surplus of the subsidiary at acquisition may be determined on a step-by-step basis.

Mr. Halvorson disagrees with the recommendation in paragraph 18. In his view, the usual subsidiary is a closely held corporation, and consequently is under no pressure to declare stock dividends and is under no compulsion to follow the "fair value" method of accounting for them if it does. If it does capitalize earned surplus by means of a stock dividend or otherwise, particularly "otherwise," he feels that it must have been done with a purpose relating to its financial position, at the direction of, and with the acquiescence of, the parent company, and that the capitalization should carry through into the consolidated surplus accounts. If the subsidiary is one in which there is a publicly held minority interest, and a stock dividend is issued and accounted for on a fair-value basis in the manner of an independent publicly owned corporation, the accounting for earned surplus in respect of the majority interest would be the same as that for the minority interest, and again he believes that the capitalization should follow through into the consolidated surplus accounts. Mr. Powell also disagrees with the conclusion expressed in this paragraph. He believes that if a parent causes a subsidiary to freeze a part or all of its earned surplus through the payment of a stock dividend or otherwise, thus making such surplus unavailable for ordinary dividends, it should follow a similar procedure on consolidation.

Mr. Kent believes the consolidation policy section is deficient since it fails to restrict the increasing practice of not including certain subsidiaries in consolidated financial statements. He suggests that the bulletin may possibly result in further increasing such practice as a consequence of the preference expressed in paragraph 19 for the inclusion of the equity in earnings of unconsolidated subsidiaries in consolidated statements. It is his belief that in the usual situation a full consolidation policy as implied in paragraph 1 is generally preferable, supplemented by such summarized financial information, in footnotes or otherwise, as may be appropriate.

Messrs. Dunn and Graham believe that the "preferable" method in paragraph 19 should be recognized as the only acceptable method of dealing with unconsolidated subsidiaries in consolidated statements, and that the method which carries the investment in unconsolidated subsidiaries at cost, and takes up as income only the dividends received, should be discontinued as rapidly as is practicable. They feel that the "preferable" method conforms to the purpose of consolidated statements as set forth in paragraph 1—to present the results of operations and the financial position essentially as if the group were a single company, and that its uniform adoption would increase the comparability of the financial statements of different companies, and would avoid the possibility of manipulation of reported consolidated earnings through the control of dividends received by the parent.

Mr. Dunn believes that paragraph 20 should require the elimination of intercompany gain on sales to unconsolidated subsidiaries if the failure to do so would have a material effect on the reported consolidated income, regardless of whether the gain on intercompany sales exceeds the unrecorded equity in undistributed earnings of the unconsolidated subsidiaries.

NOTES

(See Introduction to Accounting Research Bulletin No. 43.)

1. Accounting Research Bulletins represent the considered opinion of at least two-thirds of the members of the committee on accounting procedure, reached on a formal vote after examination of the subject matter by the committee, the technical services department, and the director of research. Except in cases in which formal adoption by the Institute membership has been asked and secured, the authority of the bulletins rests upon the general acceptability of opinions so reached.

2. Opinions of the committee are not intended to be retroactive unless they contain a statement of such intention. They should not be considered applicable to the accounting for transactions arising prior to the publication of the opinions. However, the committee does not wish to discourage the revision of past accounts in an individual case if the accountant thinks it desirable in the circumstances. Opinions of the committee should be considered as applicable only to items which are material and significant in the relative circumstances.

3. It is recognized also that any general rules may be subject to exception; it is felt, however, that the burden of justifying departure from accepted procedures must be assumed by those who adopt other treatment. Except where there is a specific statement of a different intent by the committee, its opinions and recommendations are directed primarily to business enterprises organized for profit.

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APB Opinion No. 1

NEW DEPRECIATION GUIDELINES AND RULES

NOVEMBER, 1962

1. This Interpretive Opinion is an extension of Chapter 10(b) of *Accounting Research Bulletin No. 43,* "Income Taxes." It concerns accounting problems which may arise in connection with the new Depreciation Guidelines and Rules issued by the United States Treasury Department Internal Revenue Service as Revenue Procedure 62-21, effective July 12, 1962.

2. The service lives suggested in the Guidelines for broad classes of depreciable assets are, in general, appreciably shorter than the individual lives given in Bulletin "F," which was previously used as a guide in the determination of deductible depreciation for income-tax purposes. The Guidelines purport to bring the lives used for income-tax purposes into line with the actual experience of taxpayers, and thereby reduce the areas of controversy as to the amount of deductible depreciation, but not to provide another type of accelerated depreciation.

3. For the first three years, either the new Guideline lives, or lives longer than the Guideline lives, may be used for income-tax purposes without challenge. Lives shorter than those found in the Guidelines may be used if they have previously been established or are justifiable as reflecting the taxpayer's existing or intended retirement and replacement practices. If the "reserve ratio" tests provided in the Procedure subsequently indicate that the lives used for income-tax purposes are not in accordance with actual retirement and replacement practices, the lives may be lengthened in accordance with the "life adjustment" tables provided in the Procedure. If the adjustment is not sufficient to bring tax and actual lives into line, the adjusted lives will then be replaced by lives determined in accordance with all of the facts and circumstances.

4. A taxpayer should carefully review the estimates of useful life of depreciable property adopted for financial accounting purposes, with the objective of conforming them with Guideline lives to the extent that the latter fall within a reasonable range of estimated useful lives applicable in his business.

5. With exceptions such as those discussed in paragraphs 6 and 7, net income for the period should not be *increased* as the result of the adoption of Guideline lives for income-tax purposes only. Accordingly, where Guideline lives shorter than the lives used for financial accounting purposes are adopted for income-tax purposes, and there is an excess of tax-return depreciation over book depreciation, provision for deferred income taxes should be made with respect to the part of the excess that is attributable to the adoption of Guideline lives, in the same manner as provided by *Accounting Research Bulletin No. 44 (Revised),* "Declining-balance Depreciation," for liberalized depreciation under the Internal Revenue Code of 1954.[1]

6. It may happen that a company has used shorter lives for accounting purposes than for tax purposes in the past, and now finds that these lives are longer than the new Guideline lives. If the lives previously used for accounting purposes are still considered reasonable, they presumably will be continued, but Guideline lives might be adopted for tax purposes. Tax-effect accounting should be introduced in this type of case only when the accumulated depreciation for tax purposes exceeds that on the books. In other words, not recording a prepaid income tax while the tax-return lives were longer than the book lives makes it unnecessary to provide for deferred income taxes until depreciation accumulated for tax purposes exceeds that for accounting purposes.[1]

7. It may develop that some regulatory authorities having jurisdiction over regulated businesses will prescribe the manner in which the tax effect of the adoption of Guideline lives for income-tax purposes only is to be dealt with for rate-making purposes. Where this is done, the principles set forth in paragraphs 8 and 9 of *Accounting Research Bulletin No. 44 (Revised)* are applicable.

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[1] It is assumed here that the cost or other book value of the property is the same as its tax basis. If it is not, the part of the difference between tax-return depreciation and book depreciation that results from the difference in basis ordinarily should be disregarded in making provision for deferred income taxes.

The Interpretive Opinion entitled "New Depreciation Guidelines and Rules" was unanimously adopted by the twenty members of the Accounting Principles Board, of whom five, Messrs. Bevis, Cannon, Moyer, Powell, and Spacek, assented with qualification.

Messrs. Bevis and Powell assent to the Interpretive Opinion as a logical extension of *Accounting Research Bulletin No. 44 (Revised)*, "Declining-balance Depreciation," which was adopted by the required majority of the former committee on accounting procedure. However, they do not wish their assents in this case to imply concurrence with those aspects of *Accounting Research Bulletin No. 44 (Revised)* from which Messrs. Donald R. Jennings and Weldon Powell dissented at the time. They believe the grounds for those dissents are still valid. They also believe that subsequent events have shown the disclosure requirements of paragraph 9 of *Accounting Research Bulletin No. 44 (Revised)* to be questionable.

Mr. Moyer assents to the Interpretive Opinion except for those sections which relate to deferred income taxes. He believes that the new Guideline lives permitted should not provide another type of accelerated depreciation but instead should permit a taxpayer to use the same estimated lives for income-tax purposes as are used for financial accounting purposes.

Mr. Cannon does not agree with paragraph 7 of the Interpretive Opinion because he does not believe a present declaration of the regulatory body on future rate-making policy is effective, nor should it be controlling as to the current reporting of current income in accordance with generally accepted accounting principles.

Mr. Spacek concurs in the Interpretive Opinion, but dissents with respect to the inclusion of paragraph 7 thereof, since it incorporates by reference paragraph 8 of *Accounting Research Bulletin 44 (Revised)*, with which he does not agree. Paragraph 8 of *ARB 44* states that regulated companies need not provide for the income taxes which, under the tax laws, are deferred but not eliminated "if it may reasonably be expected that increased future income taxes . . . will be allowed in future rate determinations." Thus, the independent public accountants, in expressing opinions on the financial statements of regulated companies, are placed in the position of having to predict not only the future action of Congress and the state legislatures, but of the regulatory commissions and courts as well. Where provisions for deferred income taxes are omitted as a result of the expectation that the increased future income taxes will be allowed in future rate determinations merely because of present regulatory practices, such practices are not sufficient evidence to support unqualified opinions by independent public accountants, particularly in view of the decision on September 27, 1962, of the second highest court of the land (United States Court of Appeals for the District of Columbia, No. 16,479, in *Panhandle Eastern Pipe Line Company v. Federal Power Commission*), which stated in part as follows:

> "We cannot change the plain purpose of these statutory sections merely because the Commission thinks they have had a 'basically dynamic and fluid effect.' Congress has not provided that, with respect to utilities, ratepayers are entitled to share in the temporary benefits resulting from the use of liberalized depreciation in computing income taxes. Such a provision, which would put utilities and unregulated companies in different categories, may be within the competence of Congress, but neither the Commission nor this court is authorized to legislate in that fashion. Moreover, if it should hereafter provide that utilities must share with their ratepayers the temporary reduction of income taxes produced by liberalized depreciation during the early years of useful life, Congress probably would also provide that ratepayers should proportionately bear the higher income taxes during the later years of the anticipated life of the facilities, when the depreciation deduction for tax purposes is relatively small."

NOTE

Unless otherwise indicated Interpretive Opinions present the considered opinion of at least two-thirds of the members of the Accounting Principles Board, reached on a formal vote after examination of the subject matter. Except where formal adoption by the Council or the membership of the Institute has been asked and secured, the authority of the opinions rests upon their general acceptability. While it is recognized that general rules may be subject to exception, the burden of justifying departures from the Board's recommendations must be assumed by those who adopt other practices.

APB Opinion No. 2

ACCOUNTING FOR THE "INVESTMENT CREDIT"

DECEMBER, 1962

1. The Revenue Act of 1962 provides for an "investment credit" which, in general, is equal to a specified percentage of the cost of certain depreciable assets acquired and placed in service after 1961. It is subject to certain statutory limitations and the amount available in any one year is used to reduce the amount of income tax payable for that year. The full amount of the investment credit is treated for income tax purposes as a reduction in the basis of the property. An investment credit once allowed is subject to recapture under certain circumstances set forth in the statute.

2. Some decision as to the nature of the investment credit, i.e., as to the *substance* of its essential characteristics, if not indispensable, is of great significance in a determination of its accounting treatment. We believe there can be but one useful conclusion as to the nature of the investment credit and that it must be determined by the weight of the pertinent factors.

3. Three concepts as to the substance of the investment credit have been considered by the Board: (a) subsidy by way of a contribution to capital; (b) reduction in taxes otherwise applicable to the income of the year in which the credit arises; and (c) reduction in a cost otherwise chargeable in a greater amount to future accounting periods.

4. There is no significant disagreement with the view that the investment credit is a factor which influences the determination of net income. The basic accounting issue before us therefore is not whether the investment credit increases net income but, rather, the accounting period(s) during which it should be reflected in the operating statement. Resolution of the accounting issue, in large part, rests upon the accounting principles relative to the realization of income. This is true for both regulated and nonregulated companies. (See paragraph 17 of this Opinion.)

5. **Subsidy by way of a contribution to capital.** This concept, in our opinion, is the least rational because it runs counter to the conclusion that the investment credit increases the net income of some accounting period(s).

6. **Tax reduction.** The argument for this concept essentially is that since the investment credit is made available by the Revenue Act of 1962 it is in substance a selective reduction in taxes related to the taxable income of the year in which the credit arises.

7. A refinement of the tax reduction concept advocates that 48% of the investment credit (the maximum extent to which the credit normally can increase net income, assuming that the income tax rate is 52%) should be recorded as a reduction of tax expense of the year in which the credit arises; the balance of 52% should be deferred to subsequent accounting periods, as provided in Chapter 10(b) of *Accounting Research Bulletin No. 43,* because of the statutory requirement that the basis of the property be reduced for tax purposes by the amount of the investment credit.

8. The General Rule of section 38 of the Revenue Act of 1962 provides that

> There shall be allowed, as a credit against the tax imposed by this chapter, the amount determined under sub-part B of this part.

The tax code has traditionally distinguished between exclusions from taxable income (which affect the computation of taxes payable on taxable income of the period) and credits to be applied to reduce taxes otherwise applicable to such taxable income (which do not enter into such computation). In our view the relevant materials support the interpretation that the investment credit is an administrative procedure to permit the taxpayer to withhold the cash equivalent of the credit from taxes otherwise payable and that it is not an element entering into the computation of taxes related to income of the period.

9. **Cost reduction.** We believe that the interpretation of the investment credit as a reduction in or offset against a cost otherwise chargeable in a greater amount to future accounting periods is supported by the weight of the pertinent factors and is based upon existing accounting principles.

10. In reaching this conclusion we have evaluated the pertinent portions of the

legislative history of the investment credit, which we regard as significant but not decisive. We also evaluated the pertinent provisions of the Revenue Act of 1962 which, as earlier stated, require that the investment credit be treated as a reduction in the basis of the property which gives rise to the credit and which contain recapture and other provisions the effect of which is to make realization of the credit dependent to some degree on future events.

11. The investment credit under certain circumstances is transferable to the lessee of qualified property. We regard it as significant that in such cases the rules and regulations of the Treasury require the lessee to reduce his taxable deduction for rent over a four, six, or eight year period, depending upon the useful life category of the property.

12. In concluding that the cost reduction concept is based upon existing accounting principles we attach substantial weight to two points in particular. First, in our opinion, earnings arise from the use of facilities, not from their acquisition. Second, the ultimate realization of the credit is contingent to some degree on future developments. Where the incidence of realization of income is uncertain, as in the present circumstances, we believe the record does not support the treatment of the investment credit as income at the earliest possible point of time. In our opinion the alternative choice of spreading the income in some rational manner over a series of future accounting periods is more logical and supportable.

CONCLUSIONS

13. We conclude that the allowable[1] investment credit should be reflected in net income over the productive life of acquired property and not in the year in which it is placed in service.

14. A number of alternative choices for recording the credit on the balance sheet has been considered. While we believe the reflection of the allowable credit as a reduction in the net amount at which the acquired property is stated (either directly or by inclusion in an offsetting account) may be preferable in many cases, we recognize as equally appropriate the treatment of the credit as deferred income, provided it is amortized over the productive life of the acquired property.

15. We believe it preferable that the statement of income in the year in which the allowable investment credit arises should be affected only by the results which flow from the accounting for the credit set forth in paragraph 13. Nevertheless, reflection of income tax provisions, in the income statement, in the amount payable (that is, after deduction of the allowable investment credit) is appropriate provided that a corresponding charge is made to an appropriate cost or expense (for example, to the provision for depreciation) and the treatment is adequately disclosed in the financial statements of the first year of its adoption.

16. An investment credit should be reflected in the financial statements only to the extent that it has been used as an offset against income tax liability. Under the statute, unused investment credits may be carried back or forward to other years. The accounting for these carrybacks and carryforwards should be consistent with the provisions of *Accounting Research Bulletin No. 43*, Chapter 10(b), "Income Taxes," paragraphs 16 and 17. The amount of a carryback of unused investment credit may be set up as an asset (a claim for refund of income taxes) and be added to the allowable investment credit in accounting for the effect of the credit in the year in which the property is placed in service. A carryforward of unused investment credit should ordinarily be reflected only in the year in which the amount becomes "allowable," in which case the unused amount would not appear as an asset. Material amounts of unused investment credits should be disclosed.

17. Authorities having jurisdiction over regulated business may require that the investment credit be accounted for in some manner not consistent with the conclusions expressed in this Opinion. We have previously stated our position on the issues involved in such a case (*The Journal of Accountancy*, December 1962, page 67—reprinted as an Addendum to this Opinion). The position there taken is intended to permit the so-called "flow through" treatment only in those circumstances where the standards described in that statement are met.

[1] The first $25,000 of income tax payable plus 25% of the remainder. See paragraph 16 for treatment of unused investment credits.

The Opinion entitled "Accounting for the 'Investment Credit'" was adopted by the assenting votes of fourteen members of the Board, of whom one, Mr. McEachren, assented with qualification. Messrs. Bevis, Black, Cannon, Powell, Tippit, and Walker dissented.

Mr. McEachren agrees with the conclusion that the investment credit should be reflected in net income over the productive life of acquired property but disagrees with the inclusion of paragraphs 9, 10, and 12 to the extent that they argue that the investment credit is a reduction of cost. Whether or not it is a reduction of cost is a question with many ramifications and subject to different interpretations under differing circumstances and in any event is not relevant to the matter here involved. He believes that the fundamental basis for the conclusion in paragraph 13 is that "earnings arise from the use of facilities; not from their acquisition."

Messrs. Bevis, Powell, and Tippit believe that the pertinent factors preponderantly support the view that the investment credit is in substance a reduction in income taxes. They consider that the generally accepted accounting principles applicable (including the pronouncements of the former Committee on Accounting Procedure, especially those relating to the accounting for income taxes and to the reporting of income, which are still in effect) preponderantly support the treatment of the investment credit as a reduction of the provision for current income taxes in the year in which the credit arises. They believe specifically, that the generation of taxable income for the year in and by itself, rather than the future productive use of the related property, effects the realization of the credit. They point out that opinions received by the Board from practitioners and businessmen make it clear that the "48-52" method discussed in paragraph 7 of the Opinion has at least as wide acceptance among these groups as the method sponsored by the majority of the Board. They believe that, in the circumstances, the "48-52" method must also be considered to have substantial authoritative support and, therefore, to be generally acceptable.

Messrs. Black and Cannon dissent from the conclusion that there is only one acceptable accounting treatment of the investment credit. While not objecting to reflecting the investment credit over the productive life of the acquired property, they believe that it would be preferable to defer only that part of the credit (52%) equivalent to the increased taxes in future years arising from the reduction in the tax base of the property acquired.

Mr. Walker concurs with the method set forth in the Opinion as the preferred basis for treatment of the investment credit, but it is his opinion that, with adequate disclosure, it should be considered an acceptable alternative to reduce the taxes of the year in which the credit arises by an appropriate portion of such credit.

NOTE

Unless otherwise indicated Opinions present the considered opinion of at least two-thirds of the members of the Accounting Principles Board, reached on a formal vote after examination of the subject matter. Except where formal adoption by the Council or the membership of the Institute has been asked and secured, the authority of the opinions rests upon their general acceptability. While it is recognized that general rules may be subject to exception, the burden of justifying departures from the Board's recommendations must be assumed by those who adopt other practices. Recommendations of the Board are not intended to be retroactive, nor applicable to immaterial items.

ADDENDUM

Accounting Principles for Regulated Industries

The following statement, referred to in paragraph 17 of the Opinion and approved by the Board, originally appeared in *The Journal of Accountancy,* December 1962, p. 67:

1. The basic postulates and the broad principles of accounting comprehended in the term "generally accepted accounting principles" pertain to business enterprises in general. These include public utilities, common carriers, insurance companies, financial institutions, and the like that are subject to regulation by government, usually through commissions or other similar agencies.

2. However, differences may arise in the application of generally accepted accounting principles as between regulated and non-regulated businesses, because of the effect

in regulated businesses of the rate-making process, a phenomenon not present in nonregulated businesses. Such differences usually concern mainly the time at which various items enter into the determination of net income in accordance with the principle of matching costs and revenues. For example, if a cost incurred by a regulated business during a given period is treated for rate-making purposes by the regulatory authority having jurisdiction as applicable to future revenues, it may be deferred in the balance sheet at the end of the current period and written off in the future period or periods in which the related revenue accrues, even though the cost is of a kind which in a nonregulated business would be written off currently. However, this is appropriate only when it is clear that the cost will be recoverable out of future revenues, and it is not appropriate when there is doubt, because of economic conditions or for other reasons, that the cost will be so recoverable.

3. Accounting requirements not directly related to the rate-making process commonly are imposed on regulated businesses by orders of regulatory authorities, and occasionally by court decisions or statutes. The fact that such accounting requirements are imposed by the government does not necessarily mean that they conform with generally accepted accounting principles. For example, if a cost, of a kind which in a nonregulated business would be charged to income, is charged directly to surplus pursuant to the applicable accounting requirements of the regulatory authority, such cost nevertheless should be included in operating expenses or charged to income, as appropriate in financial statements intended for use by the public.

4. The financial statements of regulated businesses other than those prepared for filing with the government for regulatory purposes preferably should be based on generally accepted accounting principles (with appropriate recognition of rate-making considerations as indicated in paragraph 2) rather than on systems of accounts or other accounting requirements of the government.

5. *Generally Accepted Auditing Standards* lists four standards of reporting, the first of which says that "The report shall state whether the financial statements are presented in accordance with generally accepted principles of accounting." In reporting on the financial statements of regulated businesses, the independent auditor should observe this standard and should deal with material variances from generally accepted accounting principles (with appropriate recognition of rate-making considerations as indicated in paragraph 2), if the financial statements reflect any such variances, in the same manner as in his reports on nonregulated businesses.

APB Opinion No. 3

THE STATEMENT OF SOURCE AND APPLICATION OF FUNDS

OCTOBER, 1963

INTRODUCTION

1. Increased attention has been given in recent years in the United States to what has generally come to be known as "Flow of Funds Analysis." For several years the Board of Governors of the Federal Reserve System has published quarterly and annual statistics in the *Federal Reserve Bulletin* showing the flow of funds in the economy. The Flow-of-Funds National Accounts of the Federal Reserve Board have joined the National Income Accounts of the Department of Commerce as important tools of national fiscal and monetary policy. Management, analysts, and investors have also become increasingly aware of the value of this aspect of financial reporting for the individual corporation.

2. Accountants have long prepared statements of source and application of funds for management, which are in fact reports on the flow of funds in individual companies. These statements have often been presented in annual reports. The concept of "funds" used in these statements has varied somewhat in practice, and variations in the concept have resulted in variations in the nature of the statements. For example, "funds" has sometimes been interpreted to mean cash or its equivalent; in such cases the resulting statement of source and application of funds is a statement of cash receipts and disbursements. The most common concept of "funds" has, however, been that of working capital, i.e., current assets less current liabilities. If the definition is applied literally, the resulting statement includes only those transactions which affect the current assets or the current liabilities. A broader interpretation identifies "funds" as all financial resources arising from transactions with parties external to the business enterprise.[1]

3. The Accounting Principles Board has considered the matter of reporting the flow of funds of a business enterprise. Certain aspects of this matter are referred to in this Opinion, including (1) the importance of information about the flow of funds, (2) the essential features of the flow of a company's funds from a reporting standpoint, and (3) the distinction between information regarding flow of funds and information regarding net income.

4. Information about the sources from which a company obtains funds and the uses to which such funds are put may be useful for a variety of purposes affecting both operating and investment decisions. Some of this information is evident from the financial statements. The statement of source and application of funds is helpful because it presents other information which ordinarily cannot be obtained from the financial statements and because it presents articulated information about the flow of funds. A statement of source and application of funds cannot supplant the income statement, but it can provide a useful and significant summary of certain transactions which, taken by themselves, have meaning, namely those affecting the flow of funds.

5. The chart on page 6513, prepared by Arthur Dahlberg, President of the U. S. Economics Corporation, shows the sources and uses of business funds in the United States. A fundamental feature of the source and application of funds shown by the chart is that all funds come either externally from borrowing or issuing equity securities or internally from revenues. Another characteristic is that the funds made available by revenues are classifiable in two distinct ways. Funds equal to the net income after deducting dividends paid to shareholders are added to the resources of the business and are available for any purpose. Funds equal to the sum of depreciation, depletion, and similar charges are also added to the resources of the business by revenues because such items, although properly deducted as operating expenses in the computation of net income, require no current

[1] Examples of different uses of the term "funds" are found in "'Cash Flow' Analysis and the Funds Statement," by Perry Mason, *Accounting Research Study No. 2*, published by the American Institute of CPAs in Nov. 1961, pp. 51-56. This study contains numerous examples of other aspects of these statements. (Accounting research studies are not statements of this Board or of the Institute but are published for the purpose of stimulating discussion on accounting issues.)

outlay of funds. They represent a partial recovery, through revenues, of funds previously spent for fixed assets and are, therefore, analytically related to current expenditure for renewals and replacements of such assets.

6. In recent years a new concept (or more correctly, an old concept with a new name) has become increasingly important in the analysis of the flow of funds. The term "cash flow" has been used to refer to a variety of concepts, but its most common meaning in financial literature, and to a lesser extent in accounting literature, is the same as "funds derived from operations" in a statement of source and application of funds. It is often defined as "net income plus depreciation," or "net income before deducting depreciation, depletion, amortization, etc." Synonyms which are sometimes used include "cash earnings," "cash income," and "cash throw-off."

7. Many of the comments made in connection with "cash flow" analysis leave the reader with the erroneous impression that "cash flow" or "cash earnings" is superior to net income as a measure of a company's real earning power. Calculations of the Price/Cash Flow ratio are sometimes made and presented as a substitute for or supplement to the Price/Earnings ratio in evaluating a company's stock. The amount of "cash flow" or the "cash flow per share" has often been presented in the president's letter, the financial review, or the statistical section of the annual report of a corporation apart from or in the absence of a complete statement of source and application of funds in the report. In other words, there has been a growing tendency on the part of some people to single out one of the items on the statement of source and application of funds, thereby implying that this figure is more important than other information regarding the flow of funds and often carrying the implication that "net income plus depreciation" is the best measure of the company's profitability. There is a strong implication running through the comments in the literature, including those in the annual reports of some corporations, that the total "cash flow" can be considered available for the payment of dividends.[3]

OPINION

8. The Board believes that a statement of source and application of funds should be presented as supplementary information in financial reports. The inclusion of such information is not mandatory, and it is optional as to whether it should be covered in the report of the independent accountant.

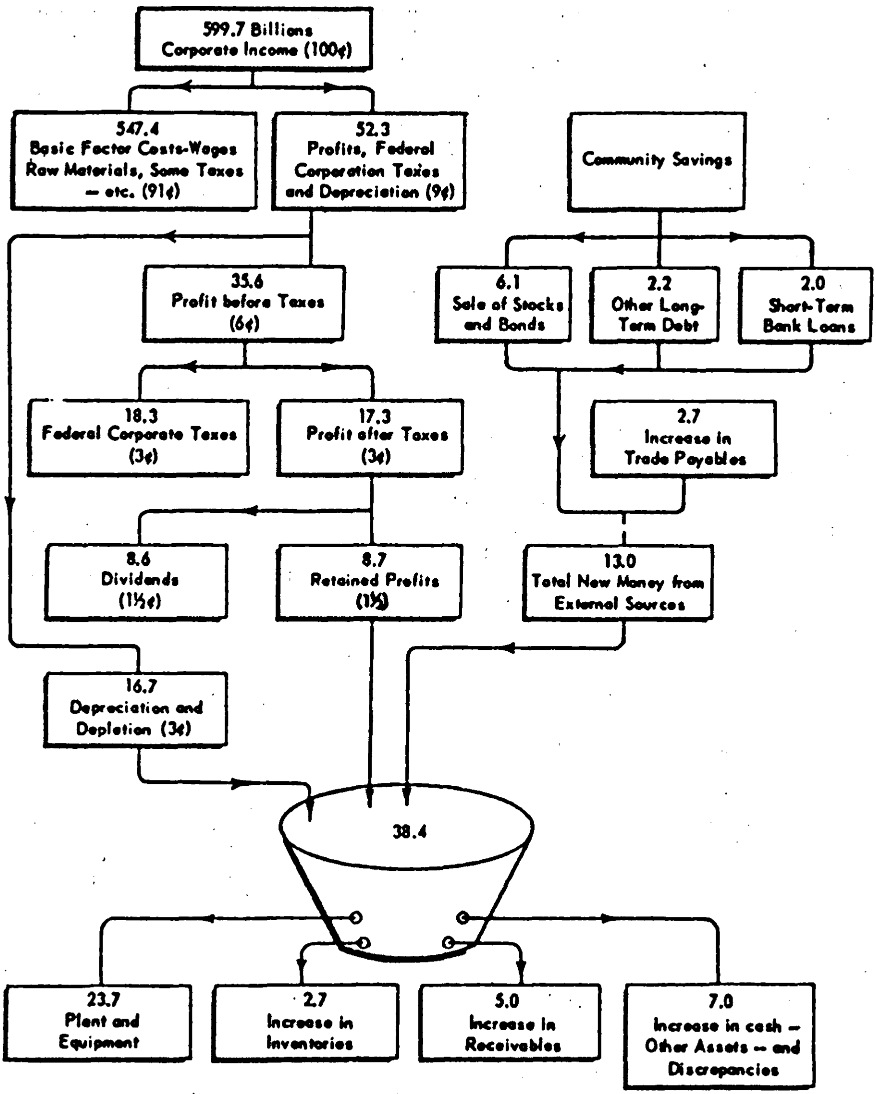
9. The concept of "funds" underlying the preparation of a statement of source and application of funds should be consistent with the purpose of the statement. In the case of statements prepared for presentation in annual reports, a concept broader than that of working capital should be used which can be characterized or defined as "all financial resources," so that the statement will include the financial aspects of all significant transactions, e.g., "non-fund" transaction such as the acquisition of property through the issue of securities.

10. Types of transactions reflected in the statement of source and application of funds may vary substantially in relative importance from one period to another. As a result, consistency of arrangement of items from period to period and uniformity of arrangement as between reporting enterprises are of less significance than in the case of the balance sheet or income statement. In a statement of source and application of funds it is desirable to disclose and to emphasize the more important financial events of the period covered by the statement. Related items should be shown together when the result contributes to the clarity of the statement, and less important items should be combined. Significant changes in individual current assets and current liabilities should be shown as separate items whenever they are not otherwise adequately disclosed in the financial statements; changes in the other current items may then be combined and shown as a single amount.

11. The title of a statement of this type should be as descriptive as possible and need not be the same in all cases. "Statement of Resources Provided and Applied" and "Statement of Source and Application of Funds" are examples of appropriate titles. Of the various forms of the statement, the preferred one follows the common practice of beginning with the funds derived from operations (net income plus or minus "non-fund" adjustments), the calculation being shown either at the beginning of the statement or in a footnote.

[3] For illustrations of these practices, see the sections, "Use of Cash Flow Concept in Financial Literature," pp. 4-15, and "Presentation of Cash Flow Data in Annual Reports," pp. 16-29, in *Accounting Research Study No. 2.*

Source and Uses of Corporate Funds for Non-Financial Business Firms
Average Year 1950—1959
(Billions of Dollars)



Source: Federal Reserve Board, Flow of Funds in the United States

From Robinson's *Understanding Profits.*

12. Both increases and decreases in capital stock (other than stock dividends or splits), in noncurrent liabilities, and in noncurrent assets should be shown where the amounts are material. The proceeds from an issue of securities should appear as a separate source of funds. Where significant in amount, the proceeds from the sale of property should be disclosed and shown separately from property acquisitions.

13. The presentation of comparative and consolidated statements of source and application of funds should conform to the policies adopted for the basic financial statements. A statement of source and application of funds which is cumulative for a period of years is sometimes prepared in addition to the statement for the current year, and is often helpful in furnishing a broad review of the financial activities over a period of time.

14. Whether or not a cash distribution to shareholders is a return of capital or a distribution of earnings can be determined only by comparing the distribution with the amount of retained earnings available. No generalization or conclusion can be drawn as to the significance of the "cash flow" without reference to the entire flow of funds as reflected in the complete statement of source and application of funds. Adding back depreciation provisions to show the total funds generated from operations can be misleading unless the reader of financial statements keeps in mind that the renewal and replacement of productive facilities require substantial "cash outflow," which may well exceed the depreciation provisions. The "funds derived from operations" (cash flow) is one, but only one, of the important items in the statement, and its significance can be determined only by relating it to the other items.

15. The amount of funds derived from operations cannot be considered as a substitute for or an improvement upon properly determined net income as a measure of results of operations and the consequent effect on financial position. Misleading implications can result from isolated statistics in annual reports of "cash flow" which are not placed in proper perspective to net income figures and to a complete analysis of source and application of funds. "Cash flow" and related terms should not be used in annual reports in such a way that the significance of net income is impaired, and "cash earnings" or other terms with a similar connotation should be avoided. The Board regards computations of "cash flow per share" as misleading since they ignore the impact of cash expenditures for renewal and replacement of facilities and tend to downgrade the significant economic statistic of "earnings per share."

The Opinion entitled "The Statement of Source and Application of Funds" was unanimously adopted by the twenty members of the Accounting Principles Board, of whom three, Messrs. Armstrong, Blough, and Spacek, assented with qualification.

Messrs. Armstrong and Blough approve the issuance of this Opinion because they believe its forceful warning against the improper preparation of "flow of funds analyses" and against their misuses is timely. However, they do not agree with the recommendation contained in paragraph 8 or the expressions contained in paragraphs 1 and 4 stating or implying that such analyses may be helpful in making investment decisions. They believe that such analyses do not deal with significant accounting matters and that relatively few investors who receive annual corporate reports are capable of using such statistical data in a useful manner. Instead, they believe their inclusion in annual reports tends to confuse most investors and affords a source of information which naive or unscrupulous persons may use to mislead the "ordinary" investor in the very ways warned against elsewhere in this Opinion.

Mr. Spacek concurs in issuance of this Opinion because he considers it to be a step in the right direction; but he does not believe that it deals adequately with the subject. In his view, since the Board believes that a funds statement should be presented in financial reports and yet does not require such presentation (par. 8), it fails in its primary responsibility of determining standards that meet the needs of investors and others who use financial statements. He states that making recommendations on the preparation of annual reports other than in the financial statements is not a Board function. He believes that the funds statement is essential for reporting to the public, and that it should be required as a part of the regular financial statements, along with the balance sheet and statements of income and surplus. He gives the illustration that no prudent corporate management, financial analyst or lending institution would evaluate the financial aspects of a business without benefit of all such statements, as a minimum; and, therefore, prudent investors who rely upon published financial statements should not be deprived of similar information.

NOTE

Opinions present the considered opinion of at least two-thirds of the members of the Accounting Principles Board, reached on a formal vote after examination of the subject matter. Except where formal adoption by the Council or the membership of the Institute has been asked and secured, the authority of the opinions rests upon their general acceptability. While it is recognized that general rules may be subject to exception, the burden of justifying departures from the Board's recommendations must be assumed by those who adopt other practices. Recommendations of the Board are not intended to be retroactive, nor applicable to immaterial items.

APB Opinion No. 4 (Amending No. 2)

ACCOUNTING FOR THE "INVESTMENT CREDIT"

MARCH, 1964

1. In December 1962 this Board issued Opinion No. 2 "Accounting for the 'Investment Credit.'" In this Opinion we said:

> Some decision as to the nature of the investment credit, i.e., as to the *substance* of its essential characteristics, if not indispensable, is of great significance in a determination of its accounting treatment. We believe there can be but one useful conclusion as to the nature of the investment credit and that it must be determined by the weight of the pertinent factors. (paragraph 2)

2. The opinion listed the possible interpretations which the Board had considered:

> Three concepts as to the substance of the investment credit have been considered by the Board: (a) subsidy by way of a contribution to capital; (b) reduction in taxes otherwise applicable to the income of the year in which the credit arises; and (c) reduction in a cost otherwise chargeable in a greater amount to future accounting periods. (paragraph 3)

3. After noting the arguments in favor of each, the Board said:

> We believe that the interpretation of the investment credit as a reduction in or offset against a cost otherwise chargeable in a greater amount to future accounting periods is supported by the weight of the pertinent factors and is based upon existing accounting principles. (paragraph 9)

4. The Board concluded (paragraph 13) that the investment credit "should be reflected in net income over the productive life of acquired property and not in the year in which it is placed in service."

5. In January 1963 the Securities and Exchange Commission issued *Accounting Series Release No. 96* in which it reported that in recognition of the substantial diversity of opinion among responsible persons in the matter of accounting for the investment credit the Commission would accept statements in which the credit was accounted for either as this Board concluded in Opinion No. 2 or as a reduction in taxes otherwise applicable to the year in which the credit arises. The Commission has recently reconsidered and reaffirmed that position.

6. The Board's review of experience since the issuance of Opinion No. 2 shows that the investment credit has been treated by a significant number of companies as an increase in net income of the year in which the credit arose.

7. The Revenue Act of 1964 eliminates the requirement imposed by the Revenue Act of 1962 that the investment credit be treated for income tax purposes as a reduction in the basis of the property to which the credit relates.

CONCLUSIONS

8. It is the conclusion of this Board that the Revenue Act of 1964 does not change the essential nature of the investment credit and, hence, of itself affords no basis for revising our Opinion as to the method of accounting for the investment credit.

9. However, the authority of Opinions of this Board rests upon their general acceptability. The Board, in the light of events and developments occurring since the issuance of Opinion No. 2, has determined that its conclusions as there expressed have not attained the degree of acceptability which it believes is necessary to make the Opinion effective.

10. In the circumstances the Board believes that, while the method of accounting for the investment credit recommended in paragraph 13 of Opinion No. 2 should be considered to be preferable, the alternative method of treating the credit as a reduction of Federal income taxes of the year in which the credit arises is also acceptable.

11. The Board emphasizes that whichever method of accounting for the investment credit is adopted, it is essential that full disclosure be made of the method followed and amounts involved, when material.

The Opinion entitled "Accounting for the 'Investment Credit'" was adopted by the assenting votes of fifteen members of the Board, of whom eight, Messrs. Bevis, Crichley, Frese, Higgins, Jennings, Queenan, Tippit and Trueblood assented with qualification. Messrs. Armstrong, Blough, Moonitz, Moyer and Spacek dissented.

Messrs. Crichley and Trueblood believe that, under the Revenue Act of 1964, there is considerable theoretical support for regarding the investment credit as a selective reduction in taxes. Accordingly, they do not necessarily regard amortization of the investment credit over the life of acquired properties as the "preferable method." They believe that the alternative method is preferable, but agree that recognition of both methods is necessary and desirable under existing conditions.

Mr. Frese assents to the conclusions in this Opinion, and to its publication, because he believes developments and circumstances summarized in paragraphs 5, 6, and 9 leave the Board no other practical choice. He desires, however, to express his strong preference for the conclusion of the Board in Opinion No. 2 because he believes it conforms with the basic concept, which has long been generally accepted, that income should be recognized as it is earned through the use of assets and not as an immediate result of their acquisition.

Messrs. Higgins and Jennings assent to Opinion No. 4 and its publication only because they believe the action of the SEC, reported in paragraph 5, and the consequences recited in paragraph 6, leave no other practicable choice. They believe that the Revenue Act of 1964 does not alter the soundness of the conclusion stated in Opinion No. 2 that the investment credit should be reflected in net income over the productive life of acquired property and not in the year in which such property is placed in service. They believe further that the present action recognizing the alternative treatment as acceptable is illogical (for the reasons given in the first sentence of Mr. Moonitz's dissent) and is tantamount to taking no position. They observe that paragraph 17 of Opinion No. 2 is still effective and, accordingly, that the alternative method of treating the credit as a reduction of Federal income tax of the year in which the credit arises is improper and should be unacceptable in those instances where Section 203(e) of the Revenue Act of 1964 effectively requires the credit to be reflected in net income over the productive life of the property.

Mr. Queenan, joined by Messrs. Bevis and Tippit, assents to the Opinion because he continues to believe that the investment credit constitutes a reduction in income tax expense in the year in which the credit arises. In view of the substantial support of the cost-reduction concept, he does not object to inclusion of the credit in net income over the life of the acquired property, but believes that the order of preference expressed in paragraph 10 should be reversed.

Mr. Armstrong dissents from Opinion No. 4. He agrees that the Revenue Act of 1964 does not change the essential nature of the investment credit and agrees with the conclusions expressed in Opinion No. 2. He disagrees with paragraph 10 of Opinion No. 4 wherein an alternative method of treating the credit is recognized as being acceptable, thereby adding one more to the list of principles for which there are a variety of acceptable methods yielding substantially different results in comparable situations.

Mr. Blough dissents from this opinion because he believes the conclusion reached in Opinion No. 2 "that the allowable investment credit should be reflected in net income over the productive life of acquired property and not in the year in which it is placed in service" was and is sound. The fact that there is substantial support for treating the investment credit as an increase in net income of the year in which the credit arose is not a sound reason, in his opinion, for this Board to retreat from a position which it still considers to be "preferable." He does not believe the Board can carry out its major responsibility "to determine appropriate practice and to narrow the areas of difference and inconsistency in practice" if it withdraws its influence from the support of its considered opinion whenever that opinion is not immediately accepted by all influential persons.

Mr. Moonitz dissents to paragraph 10 of Opinion No. 4 because while it is conceivable that the tax reduction method may be right, or that cost reduction may be right, or that both are wrong and some other unspecified possibility right, the investment credit cannot be two different things at one and the same time. As between the two methods set forth in paragraph 10, he believes that accounting principles compel the treatment of the investment credit as a selective reduction in tax available to those who meet the conditions laid down in the statute. The method preferred by the majority of the Board permits identical items bought from the same supplier at identical prices to be recorded at different "costs" depending upon the tax status of the purchaser and not upon the conditions prevailing in the transaction between buyer and seller. Alternatively the method preferred by the majority of the Board permits the balance sheet to include a "deferred credit to income" that cannot be classified as part of the interest of owners, creditors, government, employees, or any other recognizable group. He concludes that the effect of Opinion No. 4 can only be the direct opposite of the Board's ultimate objective of narrowing the areas of difference in practice.

Mr. Moyer believes that Opinion No. 4 should not have been issued, as it carries the strong implication that Opinions of the Board always should follow existing practices. He believes that progress cannot be made under such a policy.

Mr. Spacek dissents from the conclusion in paragraph 10. He believes this Opinion illustrates the accounting profession's complete failure in its responsibility to establish accounting principles that will provide reliable financial statements that are comparable among companies and industries, for use of the public in making personal investment decisions. He states there is no justification for sanctioning two contradictory practices to accommodate SEC and other regulatory bodies and some CPAs who have approved reporting the investment credit as, in effect, profit from acquisition rather than from use of property. This flouts Congress' clear intent in granting the investment credit, "to reduce the net cost of acquiring depreciable property." Alternative procedures under this Opinion can increase by up to 25 per cent the earnings otherwise reported. In this Opinion and in SEC's stated position, Mr. Spacek finds no word of concern for the investor, to whose protection both CPAs and SEC supposedly are dedicated. He believes this Opinion approves accounting of the type that precipitated the 1929 financial crisis, and that history is being repeated by actions of the very authorities created to prevent such catastrophes. He feels this breakdown in safeguards created to protect investors has resulted from fragmentation of responsibility for establishing accounting principles, and the only remedy is to create a Federally established Court of Accounting Principles with a prescribed basis for its decisions; this court would be independent of the profession and regulatory commissions, and its decisions would be binding on all, thus rescuing investors from their present abandonment.

NOTE

Opinions present the considered opinion of at least two-thirds of the members of the Accounting Principles Board, reached on a formal vote after examination of the subject matter. Except where formal adoption by the Council or the membership of the Institute has been asked and secured, the authority of the opinions rests upon their general acceptability. While it is recognized that general rules may be subject to exception, the burden of justifying departures from the Board's recommendations must be assumed by those who adopt other practices. Recommendations of the Board are not intended to be retroactive, nor applicable to immaterial items.

Accounting Principles Board (1963-1964)

Alvin R. Jennings, *Chairman*
Marshall S. Armstrong
Herman W. Bevis
Carman G. Blough
W. A. Crichley
Walter F. Frese
Ira N. Frisbee
Thomas G. Higgins
LeRoy Layton
Maurice Moonitz
C. A. Moyer
Louis H. Penney
John Peoples
John W. Queenan
Ira A. Schur
Leonard Spacek
Hassel Tippit
Robert M. Trueblood
Wilbert A. Walker
Robert E. Witschey

APB Opinion No. 5

REPORTING OF LEASES IN FINANCIAL STATEMENTS OF LESSEE

SEPTEMBER, 1964

INTRODUCTION

1. This Opinion sets forth the Board's views as to proper procedures or methods for implementing generally accepted accounting principles governing accounting for assets and liabilities and income and expense with respect to leases and sale and leasebacks. It supersedes Chapter 14 of *Accounting Research Bulletin No. 43*, "Disclosure of Long-Term Leases in Financial Statements of Lessees." This Opinion makes no distinction between leases of real property and leases of personal property. Because of the highly specialized problems involved, this Opinion does not apply to agreements concerning natural resources such as oil, gas, timber and mineral rights.

2. The two principal recommendations of Chapter 14 of *Accounting Research Bulletin No. 43* were:

> (1) . . . where the rentals or other obligations under long-term leases are material in the circumstances, the committee is of the opinion that:
>
> (a) disclosure should be made in financial statements or in notes thereto of:
>
> (1) the amounts of annual rentals to be paid under such leases with some indication of the periods for which they are payable and
>
> (2) any other important obligation assumed or guarantee made in connection therewith;
>
> (b) the above information should be given not only in the year in which the transaction originates but also as long thereafter as the amounts involved are material; and
>
> (c) in addition, in the year in which the transaction originates, there should be disclosure of the principal details of any important sale-and-lease transaction.
>
> (2) . . . the committee is of the opinion that the facts relating to all such leases should be carefully considered and that, where it is clearly evident that the transaction involved is in substance a purchase, the "leased" property should be included among the assets of the lessee with suitable accounting for the corresponding liabilities and for the related charges in the income statement.

3. In the period since the issuance of the Bulletin, the practice of obtaining by lease the right to use property has continued on an important scale. Although relatively more information about leases has been disclosed in financial statements of lessees in recent years, no consistent pattern has emerged, and the extent of disclosure of pertinent information has often been inadequate. In addition, there have been relatively few instances of capitalization of leased property and recognition of the related obligation, which suggests that the criteria for determining when a lease is in substance a purchase require clarification.

4. The situation described in the preceding paragraph caused the accounting research division of the American Institute of Certified Public Accountants to undertake a research study on reporting of leases in financial statements.[1] This study recommended, in part:

> . . . To the extent then that leases give rise to property rights, those rights and related liabilities should be measured and incorporated in the balance sheet.
>
> The major question then is what leases, or parts of leases, give rise to property rights. . . . (p. 4)

[1] *Accounting Research Study No. 4*, "Reporting of Leases in Financial Statements," by John H. Myers, published for its accounting research division by the American Institute of Certified Public Accountants in May, 1962. (Accounting research studies are not statements of this Board or of the Institute but are published for the purpose of stimulating discussion on important accounting issues.)

To the extent, then, that the rental payments represent a means of financing the acquisition of property rights which the lessee has in his possession and under his control, the transaction constitutes the acquisition of an asset with a related obligation to pay for it. To the extent, however, that the rental payments are for services such as maintenance, insurance, property taxes, heat, light, and elevator service, no asset has been acquired, and none should be recorded. . . .

The measurement of the asset value and the related liability involves two steps: (1) the determination of the part of the rentals which constitutes payment for property rights, and (2) the discounting of those rentals at an appropriate rate of interest. . . .

On the balance sheet the property rights acquired under lease should be grouped with the other property accounts, but probably separately classified in order to disclose the existence of the lease arrangement. The liability should be divided into its current and long-term portions and shown in the appropriate classification. . . . (p. 5)

In effect, the proposed balance-sheet treatment removes the charge for "rent" in the [income statement] accounts as an occupancy cost and instead treats it simply as a payment of an obligation and interest thereon. In its place is put "amortization of property right acquired under lease" (an occupancy cost) and "interest" (a financial expense). In the case of manufacturing concerns there probably would be a related effect on the valuation of work in process and of finished goods. (p. 6)

5. The Accounting Principles Board has considered the recommendations and the supporting argument presented in *Accounting Research Study No. 4*. The Board agrees that the nature of some lease agreements is such that an asset and a related liability should be shown in the balance sheet, and that it is important to distinguish this type of lease from other leases. The Board believes, however, that the distinction depends on the issue of whether or not the lease is in substance a purchase of the property rather than on the issue of whether or not a property right exists. The Board believes that the disclosure requirements regarding leases contained in *Accounting Research Bulletin No. 43*, Chapter 14, should be extended, and the criteria for identification of lease agreements which are in effect installment purchases of property should be clarified. The Board also believes that accounting for gains and losses on sale-and-leaseback transactions should be specifically dealt with in this Opinion.

DISCUSSION

6. The central question is whether assets and liabilities are created by leases which convey the right to use property if no equity is accumulated in the property by the lessee. Chapter 14 of *Accounting Research Bulletin No. 43* and *Accounting Research Study No. 4* agree that leases which are clearly in substance purchases result in assets and liabilities which should be recorded, and that to the extent rental payments are for services, such as property taxes, utilities, maintenance, and so forth, they should be charged to current operations. They disagree with regard to leases which convey merely the right to use property in consideration of specified rental payments over a definite future period.

7. It seems clear that leases covering merely the right to use property in exchange for future rental payments do not create an equity in the property and are thus nothing more than executory contracts requiring continuing performance on the part of both the lessor and the lessee for the full period covered by the leases. The question of whether assets and liabilities should be recorded in connection with leases of this type is, therefore, part of the larger issue of whether the rights and obligations that exist under executory contracts in general (e.g., purchase commitments and employment contracts) give rise to assets and liabilities which should be recorded.

8. The rights and obligations related to unperformed portions of executory contracts are not recognized as assets and liabilities in financial statements under generally accepted accounting principles as presently understood. Generally accepted accounting principles require the disclosure of the rights and obligations under executory contracts in separate schedules or notes to the financial statements if the omission of this information would tend to make the financial statements misleading. The rights and obligations under leases which convey merely the right to use property, without an equity in the property accruing to the lessee, fall into the category of pertinent information which

should be disclosed in schedules or notes rather than by recording assets and liabilities in the financial statements.

9. On the other hand, some lease agreements are essentially equivalent to installment purchases of property. In such cases, the substance of the arrangement, rather than its legal form, should determine the accounting treatment. The property and the related obligation should be included in the balance sheet as an asset and a liability, respectively, at the discounted amount of the future lease rental payments, exclusive of payments to cover taxes and operating expenses other than depreciation. Further, in such cases, it is appropriate to depreciate the capitalized amount for property over its estimated useful life rather than over the initial period of the lease.

10. The property and the related obligation should be included as an asset and a liability in the balance sheet if the terms of the lease result in the creation of a material equity in the property. It is unlikely that such an equity can be created under a lease which either party may cancel unilaterally for reasons other than the occurrence of some remote contingency. The presence, in a noncancelable lease or in a lease cancelable only upon the occurrence of some remote contingency, of either of the two following conditions will usually establish that a lease should be considered to be in substance a purchase:

a. The initial term is materially less than the useful life of the property, and the lessee has the option to renew the lease for the remaining useful life of the property at substantially less than the fair rental value; or
b. The lessee has the right, during or at the expiration of the lease, to acquire the property at a price which at the inception of the lease appears to be substantially less than the probable fair value of the property at the time or times of permitted acquisition by the lessee.

In these cases, the fact that the rental payments usually run well ahead of any reasonable measure of the expiration of the service value of the property, coupled with the options which permit either a bargain purchase by the lessee or the renewal of the lease during the anticipated useful life at bargain rentals, constitutes convincing evidence that an equity in the property is being built up as rental payments are made and that the transaction is essentially equivalent to a purchase.

11. The determination that lease payments result in the creation of an equity in the property obviously requires a careful evaluation of the facts and probabilities surrounding a given case. Unless it is clear that no material equity in the property will result from the lease, the existence, in connection with a noncancelable lease or a lease cancelable only upon the occurrence of some remote contingency, of one or more circumstances such as those shown below tend to indicate that the lease arrangement is in substance a purchase and should be accounted for as such.

a. The property was acquired by the lessor to meet the special needs of the lessee and will probably be usable only for that purpose and only by the lessee.
b. The term of the lease corresponds substantially to the estimated useful life of the property, and the lessee is obligated to pay costs such as taxes, insurance, and maintenance, which are usually considered incidental to ownership.
c. The lessee has guaranteed the obligations of the lessor with respect to the property leased.
d. The lessee has treated the lease as a purchase for tax purposes.

12. In cases in which the lessee and the lessor are related, leases should often be treated as purchases even though they do not meet the criteria set forth in paragraphs 10 and 11, i.e., even though no direct equity is being built up by the lessee. In these cases, a lease should be recorded as a purchase if a primary purpose of ownership of the property by the lessor is to lease it to the lessee and (1) the lease payments are pledged to secure the debts of the lessor or (2) the lessee is able, directly or indirectly, to control or influence significantly the actions of the lessor with respect to the lease. The following illustrate situations in which these conditions are frequently present:

a. The lessor is an unconsolidated subsidiary of the lessee, or the lessee and the lessor are subsidiaries of the same parent and either is unconsolidated.
b. The lessee and the lessor have common officers, directors, or shareholders to a significant degree.
c. The lessor has been created, directly or indirectly, by the lessee and is substantially dependent on the lessee for its operations.
d. The lessee (or its parent) has the right, through options or otherwise, to acquire control of the lessor.

OPINION

Application of Opinion

13. This Opinion is concerned with accounting for noncancelable leases (or leases cancelable only upon the occurrence of some remote contingency) which are material, either individually or as a group for similar types of property, or in the aggregate. The presumption is that if the rights and obligations under such leases are either material in relation to the lessee's net assets or reasonably expected to affect materially the results of operations of future periods, the leases are covered by the provisions of this Opinion.

Capitalization

14. Except in cases of leases which come under paragraphs 9, 10, 11, and 12 of this Opinion, the right to use property and a related obligation to pay specific rents over a definite future period are not considered by the Board to be assets and liabilities under present accounting concepts (see paragraphs 6, 7 and 8). Leases of this type involve future rights and obligations, however, and pertinent information should be disclosed as described in paragraphs 16, 17, and 18. In the opinion of the Board, disclosure rather than capitalization is the correct accounting treatment of these leases.

15. Leases which are clearly in substance installment purchases of property (see paragraphs 9, 10, 11, and 12) should be recorded as purchases. The property and the obligation should be stated in the balance sheet at an appropriate discounted amount of future payments under the lease agreement. A note or schedule may be required to disclose significant provisions of the transaction. The method of amortizing the amount of the asset to income should be appropriate to the nature and use of the asset and should be chosen without reference to the period over which the related obligation is discharged.

Disclosure

16. The Board believes that financial statements should disclose sufficient information regarding material, noncancelable leases which are not recorded as assets and liabilities (see paragraphs 13 and 14) to enable the reader to assess the effect of lease commitments upon the financial position and results of operations, both present and prospective, of the lessee. Consequently, the financial statements or the accompanying notes should disclose the minimum annual rentals under such leases and the period over which the outlays will be made.

17. In many cases, additional disclosure will be required. The Board believes that rentals for the current year on leases covered by this Opinion should be disclosed if they differ significantly from the minimum rentals under the leases. Type or types of property leased, obligations assumed or guarantees made, and significant provisions of lease agreements (such as restrictions on dividends, debt, or further leasing or unusual options) are examples of other types of information which should also usually be disclosed.

18. The specific details to be disclosed and the method of disclosure will vary from one situation to another depending upon the circumstances. In many cases, a simple statement will suffice. In more complicated situations, more detailed disclosure will be appropriate. For example, it may be useful to provide a schedule of rentals by years or by three- or five-year periods if annual rentals will fluctuate significantly; or it may be desirable to provide a brief description of the basis for calculating the rental if the amount of rent is dependent upon some factor other than the lapse of time; or it may be necessary to indicate the effect of lease renewals in order to avoid misleading implications.

Sale and Leaseback

19. The principal details of any material sale-and-leaseback arrangement should be disclosed in the year in which the transaction originates.

20. The conclusions in paragraphs 14, 15, 16, 17, and 18 apply to the agreement covering the leaseback as through no concurrent sale were involved.

21. The Board is of the opinion that the sale and the leaseback usually cannot be accounted for as independent transactions. Neither the sale price nor the annual rental can be objectively evaluated independently of the other. Consequently, material gains or losses resulting from the sale of properties which are the subject of sale-and-leaseback transactions, together with the related tax effect, should be amortized over the life of the lease as an adjustment of the rental cost (or, if the leased property is capitalized, as an adjustment of depreciation).

22. Exceptions to the rule in paragraph 21 are expected to be rare. If, however, the fair value of the property at the time of the

sale and leaseback is less than the undepreciated cost, the loss should be reflected in income at the time of the sale to the extent that a write-down to recognize fair value could properly have been recorded in the absence of a sale. In other instances in which the use of the leased property changes with the sale and leaseback and in which the sale price falls within the limits which would reasonably be set by independent transactions (for example, companies engaged in both constructing and operating office buildings or other commercial investment properties may sell a property after construction and lease it back for operation), the exceptional circumstances surrounding a particular sale-and-leaseback transaction may clearly justify recognition of all or part of the gain or loss at the time of the sale.

Prior Lease Agreements

23. Unless otherwise stated, Opinions of the Board are not intended to be retroactive. However, the Board encourages the revision of past accounts in individual cases where the effect on current financial statements is material. In any event, the Board believes the conclusions as to disclosure stated in paragraphs 16, 17, and 18 should apply to lease agreements made prior to the issuance of this Opinion.

The Opinion entitled "Reporting of Leases in Financial Statements of Lessee" was adopted by the assenting votes of twenty members of the Board, of whom two, Messrs. Moonitz and Walker, assented with qualification. Mr. Spacek dissented.

Mr. Moonitz assents to the publication of this Opinion because he believes that it will increase the disclosure of pertinent information regarding leases in published financial statements. He does not believe that this Opinion resolves the underlying issue of the nature of assets and of liabilities. He dissents to paragraph 21, which evidences the confusion concerning assets and liabilities. Paragraph 21 recommends that gains or losses from sale-and-leaseback transactions be amortized over the life of the lease. The adoption of this recommendation in practice will result in the introduction into the balance sheet of "deferred credits to income" for gains and "deferred charges to income" for losses. In a sale-and-leaseback transaction, neither of these deferred items qualifies as a liability or as an asset. Their effect is to permit a smoothing of reported net income over a number of years. This result stems from the attempt to treat the transaction as though no sale has been made, insofar as the effect on net income is concerned, while treating the property as sold in the balance sheet. If the property has in fact been sold, it should be so reported in consistent fashion in all the financial statements. If it has not, the balance sheet should not be made to report that it has.

Mr. Walker assents to the conclusions of this Opinion. He believes, however, that adequate disclosure with respect to leases which are considered to be essentially equivalent to installment purchases can be made as well by notes to the financial statements as by inclusion in the figures. Such disclosure is more appropriate because of the legal status and avoids inflating the balance sheet with questionable assets and liabilities.

Mr. Spacek dissents from the principal conclusion that a lease liability should be shown on the balance sheet only when the lease, because of an element of prepaid rent (referred to in this Opinion as "equity") arising from the early lease payments, is interpreted to be an agreement to purchase. In his view, a liability (discounted to present value) should be recorded for all material amounts payable under noncancelable leases, which in fact are "take or pay" contracts, representing a present liability payable in the future. The payment of this obligation has a call on other corporate assets, ahead of corporate equity applicable to investors; and, thus, a liability should be shown on the face of the balance sheet, rather than being relegated to inadequate footnote disclosure. He considers this "equity" to be prepaid rent which should be deferred to the periods to which it applies. It is incorrect to assume that only when rental charges are thus determined to be excessive in early periods does a recordable obligation for future payments result, since this leads to the unsupportable conclusion that the payment of prepaid rent creates a liability and the nonexistence of prepaid rent eliminates the liability. He further believes this Opinion (a) does not explain why its major conclusions disagree with those in *Research Study No. 4,* and (b) establishes criteria for recording lease obligations on an unrealistic and impracticable basis which compounds the ineffective provisions of ARB 43 that have not met the needs of investors and other users of financial statements.

NOTE

Opinions present the considered opinion of at least two-thirds of the members of the Accounting Principles Board, reached on a formal vote after examination of the subject matter. Except where formal adoption by the Council or the membership of the Institute has been asked and secured, the authority of the opinions rests upon their general acceptability. *While it is recognized that general rules may be subject to exception, the burden of justifying departures from the Board's recommendations must be assumed by those who adopt other practices. Recommendations of the Board are not intended to be retroactive, nor applicable to immaterial items.*

APB Opinion No. 6

STATUS OF ACCOUNTING RESEARCH BULLETINS

OCTOBER, 1965

1. On October 2, 1964, Council of the Institute adopted recommendations[1] requiring that departures from accounting principles accepted in Board Opinions and Accounting Research Bulletins be disclosed in footnotes to financial statements or in independent auditors' reports when the effect of any such departure on the financial statements is material. This requirement is applicable to financial statements for fiscal periods that begin after December 31, 1965.

2. Concurrently, in a related action,[1] Council directed the Accounting Principles Board to review all Accounting Research Bulletins prior to December 31, 1965, and determine whether any of them should be revised or withdrawn.

3. In accordance with this directive, the Board has reviewed all outstanding Accounting Research Bulletins. These consist of Numbers 43 (including Preface, Introduction and Appendices) through 51,[2] except:

a. Chapter 7C of ARB 43, which was superseded in 1957 by ARB 48;

b. Chapter 14 of ARB 43, which was superseded in 1964 by Board Opinion 5; and

c. ARB 44, which was superseded in July 1958 by ARB 44 (Revised).

For convenience, individual chapters and sub-chapters of Accounting Research Bulletin No. 43 are, at times, referred to as "Bulletins" in this Opinion.

4. A number of matters currently under study or planned for study by the Board are directly related to matters discussed in the Bulletins. It is the present intention of the Board to make some of these subjects of Opinions as soon as practicable. Accordingly, the language, form and substance of some of the Bulletins may be changed at a later date.

5. Nevertheless, the Board believes that the considerations which gave rise to the conclusions set forth in some of the bulletins may no longer apply with the same force as when the Bulletins were issued, and that, pending further consideration by the Board, it should revise certain of the Bulletins in order to obviate conflicts between present accepted practice and provisions of outstanding Bulletins which would otherwise require unwarranted disclosure under the action of Council.[3]

6. The Board's review at this time, accordingly, was confined primarily to substantive matters in the Bulletins, and the revisions set forth in this Opinion are made in the light of currently accepted practices followed in preparing financial statements and reporting upon them. In addition, it has approved revisions designed to clarify parts of some of the Bulletins and to express its conclusions on certain matters not covered specifically in the Bulletins.

7. In making its review, the Board has interpreted the disclosure requirement approved by Council to apply, with equal force, to departures from the provisions of Accounting Research Bulletins and Board Opinions that relate not only to accounting principles followed in the preparation of the financial statements but also to the form and content of financial statements and to the disclosure of information. For purposes of carrying out Council's requirement, the Board construes the term "accounting principles" to include not only principles and practices, but also the methods of applying them.[4]

8. Some Accounting Research Bulletins and Board Opinions contain expressions of preference as to accounting principles, including form and content of financial statements and the disclosure of information, although other principles are stated to be acceptable. Under these circumstances, when one of the principles accepted in the Bulletin or Opinion is applied in financial statements, disclosure of a departure from the *preferred* principle is not required. On

[1] Special Bulletin, *Disclosure of Departures From Opinions of Accounting Principles Board*, October 1964. (Reprinted in Appendix A of this Opinion.)

[2] ARB Nos. 1-42 were cancelled and replaced by ARB 43, and by Accounting Terminology Bulletin No. 1, both issued in 1953.

[3] Special Bulletin, *Disclosure of Departures From Opinions of Accounting Principles Board*, October 1964. (Reprinted in Appendix A of this Opinion.)

[4] Statement on Auditing Procedure No. 33, *Auditing Standards and Procedures*, paragraph 2, page 40.

the other hand, the language of some Accounting Research Bulletins and Board Opinions indicates that one or more specified principles are acceptable, and, directly or by implication, that others are not. In such cases, departures from the *specified* principles must be disclosed.

9. The Preface and Appendices of ARB 43 explain what revisions the Committee on Accounting Procedure made to previously issued Bulletins and why certain revisions were made; therefore, the Board considers this material to be primarily of historical value. With respect to the Introduction, paragraph 8 has been expanded as to disclosure requirements by the action of Council on October 2, 1964.[5]

10. The following paragraphs (12 through 23) of this Opinion set forth the Board's conclusions as to the extent to which currently outstanding Bulletins should be revised at this time. Except for these revisions, these and all other currently existing Bulletins continue in full force and effect without change.

BULLETINS REVISED

11. The following Bulletins are revised, in part, by this Opinion.

ARB 43, Chapter 1B—Treasury Stock

12. The Board considers that the following accounting practices, in addition to the accounting practices indicated in Chapter 1B, are acceptable, and that they appear to be more in accord with current developments in practice:

a. When a corporation's stock is retired, or purchased for constructive retirement (with or without an intention to retire the stock formally in accordance with applicable laws):

   i. *an excess of purchase price over par or stated value* may be allocated between capital surplus and retained earnings. The portion of the excess allocated to capital surplus should be limited to the sum of (a) all capital surplus arising from previous retirements and net "gains" on sales of treasury stock of the same issue and (b) the prorata portion of capital surplus paid in, voluntary transfers of retained earnings, capitalization of stock dividends, etc., on the same issue. For this purpose, any remaining capital surplus applicable to issues fully retired (formal or constructive) is deemed to be applicable prorata to shares of common stock. Alternatively, the excess may be charged entirely to retained earnings in recognition of the fact that a corporation can always capitalize or allocate retained earnings for such purposes.

   ii. *an excess of par or stated value over purchase price* should be credited to capital surplus.

b. When a corporation's stock is acquired for purposes other than retirement (formal or constructive), or when ultimate disposition has not yet been decided, the cost of acquired stock may be shown separately as a deduction from the total of capital stock, capital surplus, and retained earnings, or may be accorded the accounting treatment appropriate for retired stock, or in some circumstances may be shown as an asset in accordance with paragraph 4 of Chapter 1A of ARB 43. "Gains" on sales of treasury stock not previously accounted for as constructively retired should be credited to capital surplus; "losses" may be charged to capital surplus to the extent that previous net "gains" from sales or retirements of the same class of stock are included therein, otherwise to retained earnings.

c. Treasury stock delivered to effect a "pooling of interests" should be accounted for as though it were newly issued, and the cost thereof should receive the accounting treatment appropriate for retired stock.

13. Laws of some states govern the circumstances under which a corporation may acquire its own stock and prescribe the accounting treatment therefor. Where such requirements are at variance with paragraph 12, the accounting should conform to the applicable law. When state laws relating to acquisition of stock restrict the availability of retained earnings for payment of dividends or have other effects of a significant nature, these facts should be disclosed.

[5] Special Bulletin, *Disclosure of Departures From Opinions of Accounting Principles Board*, October 1964. (Reprinted in Appendix A of this Opinion.)

ARB 43, Chapter 3A—Current Assets and Current Liabilities

14. The following paragraph is added to this chapter:

10. Unearned discounts (other than cash or quantity discounts and the like), finance charges and interest included in the face amount of receivables should be shown as a deduction from the related receivables.

ARB 43, Chapter 5—Intangible Assets

15. The last sentence of paragraph 7 of Chapter 5 is deleted.

ARB 43, Chapter 7B—Stock Dividends and Stock Split-Ups

16. The Board is of the opinion that paragraph 6 should not be construed as prohibiting the equity method of accounting for substantial intercorporate investments. This method is described in paragraph 19 of ARB 51.

ARB 43, Chapter 9B—Depreciation on Appreciation

17. Paragraphs 1 and 2 are deleted and the following paragraph is substituted for them:

1. The Board is of the opinion that property, plant and equipment should not be written up by an entity to reflect appraisal, market or current values which are above cost to the entity. This statement is not intended to change accounting practices followed in connection with quasi-reorganizations[*] or reorganizations. This statement may not apply to foreign operations under unusual conditions such as serious inflation or currency devaluation. However, when the accounts of a company with foreign operations are translated into United States currency for consolidation, such write ups normally are eliminated. Whenever appreciation has been recorded on the books, income should be charged with depreciation computed on the written up amounts.

Mr. Davidson agrees with the statement that at the present time "property, plant and equipment should not be written up" to reflect current costs, but only because he feels that current measurement techniques are inadequate for such restatement. When adequate measurement methods are developed, he believes that both the reporting of operations in the income statement and the valuation of plant in the balance sheet would be improved through the use of current rather than acquisition costs. In the meanwhile, strong efforts should be made to develop the techniques for measuring current costs.

ARB 43, Chapter 12—Foreign Operations and Foreign Exchange

18. Paragraphs 12 and 18 state that long-term receivables and long-term liabilities should be translated at historical exchange rates. The Board is of the opinion that translation of long-term receivables and long-term liabilities at current exchange rates is appropriate in many circumstances.

ARB 43, Chapter 15—Unamortized Discount, Issue Cost, and Redemption Premium on Bonds Refunded

19. Paragraph 12 is amended to read as follows:

12. The third method, amortization over the life of the new issue, is appropriate under circumstances where the refunding takes place because of currently lower interest rates or anticipation of higher interest rates in the future. In such circumstances, the expected benefits justify spreading the costs over the life of the new issue, and this method is, therefore, acceptable. Paragraph 11 of this chapter is applicable when this method is adopted.

ARB 44 (Revised) — Declining-Balance Depreciation

20. Pending further study, paragraph 9 is revised to read as follows:

9. When a company subject to rate-making processes adopts the declining-balance method of depreciation for income tax purposes but adopts other appropriate methods for financial accounting purposes in the circumstances described in paragraph 8, and does not give accounting recog-

[*] See Accounting Research Bulletin No. 43, Chapter 7A, *Quasi-Reorganization or Corporate Readjustment.*

nition to deferred income taxes, disclosure should be made of this fact.

Messrs. Donald J. Bevis, Catlett, Layton, Moonitz, Penney, Schur, and Weston do not agree with paragraph 20 of this Opinion because it deletes a requirement in paragraph 9 of Accounting Research Bulletin No. 44 (Revised) for the disclosure of information they consider to be essential in financial statements. Paragraph 9 has required full disclosure of the effect ". . . arising out of the difference between the financial statements and the tax returns when the declining-balance method is adopted for income-tax purposes but other appropriate methods are used for financial accounting purposes" in the case of companies which (pursuant to paragraph 8) are not required to give accounting recognition to such differences. The intent of paragraph 20 of this Opinion is to continue the requirement for disclosure of the accounting practice followed but to omit the previous requirement for disclosure of the effect of the practice. Thus, in their opinion, the Accounting Principles Board is inappropriately sponsoring the viewpoint that investors and other users of financial statements should be told of the practice but need not be furnished the information to judge its significance.

21. The letter of April 15, 1959, addressed to the members of the Institute by the Committee on Accounting Procedure, interpreting ARB 44 (Revised), is continued in force.

ARB 48—Business Combinations

22. The Board believes that Accounting Research Bulletin No. 48 should be continued as an expression of the general philosophy for differentiating business combinations that are purchases from those that are poolings of interests, but emphasizes that the criteria set forth in paragraphs 5 and 6 are illustrative guides and not necessarily literal requirements.

Deferred Income Taxes

23. Provisions for deferred income taxes may be computed either (a) at the tax rate for the period in which the provision is made (the so-called "deferred credit" approach) or (b) at the tax rate which it is estimated will apply in the future (the so-called "liability" approach).[7]

(a) Under the deferred credit method, the accumulated balance is not adjusted for changes in tax rates subsequent to the year of provision. Accordingly, the deferred amount is allocated to (drawn down in) the future periods based on the recorded tax benefit, which may be at a rate different from the then current rate.

(b) Under the liability method, the accumulated balance is adjusted for changes in tax rates subsequent to the year of provision.[8] Accordingly, the deferred amount after adjustment is allocated to (drawn down in) the future periods based on the then current tax rates.

All provisions of Accounting Research Bulletins and Board Opinions in conflict with this paragraph are modified accordingly, including Chapter 9C and Chapter 10B of ARB 43 and ARB 44 (Revised).

EFFECTIVE DATE OF THIS OPINION

24. This Opinion shall be effective for fiscal periods that begin after December 31, 1965. However, the Board encourages earlier application of the provisions of this Opinion.

The Opinion entitled "Status of Accounting Research Bulletins" was adopted unanimously by the twenty-one members of the Board, of whom one, Mr. Davidson, assented with qualification as to paragraph 17 and seven, Messrs Donald J. Bevis, Catlett, Layton, Moonitz, Penney, Schur, and Weston assented with qualification as to paragraph 20.

[7] For a discussion of this subject see Accounting Research Study No. 7, *Inventory of Generally Accepted Accounting Principles for Business Enterprises*, p. 114.

[8] See Accounting Research Bulletin No. 43, Chapter 8—Paragraph 11.

NOTES

Opinions present the considered opinion of at least two-thirds of the members of the Accounting Principles Board, reached on a formal vote after examination of the subject matter.

Except as indicated in the succeeding paragraph, the authority of the Opinions rests upon their general acceptability. While it is recognized that general rules may be subject to exception, the burden of justifying departures from Board Opinions must be assumed by those who adopt other practices.

Action of Council of the Institute (Special Bulletin, Disclosure of Departures From Opinions of Accounting Principles Board, *October 1964) provides that:*

a. "Generally accepted accounting principles" are those principles which have substantial authoritative support.

b. Opinions of the Accounting Principles Board constitute "substantial authoritative support".

c. "Substantial authoritative support" can exist for accounting principles that differ from Opinions of the Accounting Principles Board.

The Council action also requires that departures from Board Opinions be disclosed in footnotes to the financial statements or in independent auditors' reports when the effect of the departure on the financial statements is material.

Unless otherwise stated, Opinions of the Board are not intended to be retroactive. They are not intended to be applicable to immaterial items.

Accounting Principles Board (1965-1966)

CLIFFORD V. HEIMBUCHER
Chairman
MARSHALL S. ARMSTRONG
DONALD J. BEVIS
HERMAN W. BEVIS
GEORGE R. CATLETT
W. A. CRICHLEY
SIDNEY DAVIDSON
PHILIP L. DEFLIESE
WALTER F. FRESE
LEROY LAYTON
ORAL L. LUPER
MAURICE MOONITZ
ROBERT J. MURPHEY
LOUIS H. PENNEY
JOHN PEOPLES
JOHN W. QUEENAN
IRA A. SCHUR
HASSEL TIPPIT
WILBERT A. WALKER
FRANK T. WESTON
ROBERT E. WITSCHEY

APPENDIX A

October, 1964

Special Bulletin

Disclosure of Departures From Opinions of Accounting Principles Board

TO MEMBERS OF THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

The Council of the Institute, at its meeting October 2, 1964, unanimously adopted recommendations that members should see to it that departures from Opinions of the Accounting Principles Board (as well as effective Accounting Research Bulletins issued by the former Committee on Accounting Procedure) are disclosed, either in footnotes to financial statements or in the audit reports of members in their capacity as independent auditors.

This action applies to financial statements for fiscal periods beginning after December 31, 1965.

The recommendations adopted by Council are as follows:

1. "Generally accepted accounting principles" are those principles which have substantial authoritative support.

2. Opinions of the Accounting Principles Board constitute "substantial authoritative support."

3. "Substantial authoritative support" can exist for accounting principles that differ from Opinions of the Accounting Principles Board.

4. No distinction should be made between the Bulletins issued by the former Committee on Accounting Procedure on matters of accounting principles and the Opinions of the Accounting Principles Board. Accordingly, references in this report to Opinions of the Accounting Principles Board also apply to the Accounting Research Bulletins.[1,2]

[1] This is in accord with the following resolution of the Accounting Principles Board at its first meeting on September 11, 1959:

"The Accounting Principles Board has the authority, as did the predecessor committee, to review and revise any of these Bulletins (published by the predecessor committee) and it plans to take such action from time to time.

"Pending such action and in order to prevent any misunderstanding meanwhile as to the status of the existing accounting research and terminology bulletins, the Accounting Principles

(Continued on next page.)

5. If an accounting principle that differs materially in its effect from one accepted in an Opinion of the Accounting Principles Board is applied in financial statements, the reporting member must decide whether the principle has substantial authoritative support and is applicable in the circumstances.

a. If he concludes that it does not, he would either qualify his opinion, disclaim an opinion, or give an adverse opinion as appropriate. Requirements for handling these situations in the reports of members are set forth in generally accepted auditing standards and in the Code of Professional Ethics and need no further implementation.

b. If he concludes that it does have substantial authoritative support:

(1) he would give an unqualified opinion and

(2) disclose the fact of departure from the Opinion in a separate paragraph in his report or see that it is disclosed in a footnote to the financial statements and, where practicable, its effects on the financial statements.* Illustrative language for this purpose is as follows:

> The company's treatment of (describe) is at variance with Opinion No. .... of the Accounting Principles Board (Accounting Research Bulletin No. .... of the Committee on Accounting Procedure) of the American Institute of Certified Public Accountants. This Opinion (Bulletin) states that (describe the principle in question). If the Accounting Principles Board Opinion (Accounting Research Bulletin) had been followed, income for the year would have been increased (decreased) by $...., and the amount of retained earnings at (date) increased (decreased) by $..... In our opinion, the company's treatment has substantial authoritative support and is an acceptable practice.
>
> * * *
>
> If disclosure is made in a footnote, the last sentence might be changed to read: In the opinion of the independent auditors, ..., the company's treatment has substantial authoritative support and is an acceptable practice.

6. Departures from Opinions of the Accounting Principles Board which have a material effect should be disclosed in reports for fiscal periods that begin:

a. After December 31, 1965, in the case of existing Bulletins and Opinions;

b. After the issue date of future Opinions unless a later effective date is specified in the Opinion.

7. The Accounting Principles Board should review prior to December 31, 1965, all Bulletins of the Committee on Accounting Procedure and determine whether any of them should be revised or withdrawn.

8. The Accounting Principles Board should include in each Opinion a notation that members should disclose a material departure therefrom.

9. The failure to disclose a material departure from an Accounting Principles Board Opinion is deemed to be substandard reporting.† The Practice Review Committee should be instructed to give its attention to this area and to specifically report to Council the extent of deviations from these recommendations.

10. The Committee on Professional Ethics and the Institute's legal counsel have advised that the present By-Laws and Code of Professional Ethics would not cover an infraction of the above recommendations. Whether the Code of Professional Ethics should be amended is a question which should be studied further.‡

* * *

As indicated in the above text, Council's action is not intended to have the force and effect of a rule of ethics, but rather that of a standard of reporting practice, deviations from which should have the attention of the Practice Review Committee.

Yours truly,

THOMAS D. FLYNN, *President*

Board now makes public announcement that these bulletins should be considered as continuing in force with the same degree of authority as before."

[3] The Terminology Bulletins are not within the purview of the Council's resolution nor of this report because they are not statements on accounting principles.

* In those cases in which it is not practicable to determine the approximate effect on the financial statements, this fact should be expressly stated.

† In discussion at the Council meeting it was explained that the phrase "substandard reporting" was used in the sense of reporting practices not in conformity with recommendations of the Council.

‡ By order of the Council a special committee is now reviewing the entire matter of the status of Opinions of the Accounting Principles Board, and the development of accounting principles and practices for the purpose of recommending to Council a general statement of philosophy, purpose and aims in this area.

APB Opinion No. 7

ACCOUNTING FOR LEASES IN FINANCIAL STATEMENTS OF LESSORS

MAY, 1966

INTRODUCTION

1. This Opinion sets forth the Board's views as to accounting for the revenue and expense related to, and the investment in, property leased to others. Because of the highly specialized problems involved, this Opinion does not apply to lease agreements concerning natural resources such as oil, gas, timber and mineral rights.

2. The principal accounting problems of lessors concern the allocation of revenue and expense to the accounting periods covered by a lease. Although the lease typically establishes a schedule of rent to be received by the lessor, the treatment of this rent as revenue in the period of receipt does not necessarily result in a fair measurement of the lessor's periodic income during the term of the lease. The allocation to accounting periods of acquisition and operating costs of the leased property and of costs of negotiating and closing the lease needs to be systematic, rational, and consistent with the method of recognizing revenue. The description and classification in the balance sheet of the investment in leasing activities is also of importance.

DISCUSSION

Leasing activities

3. Lessors may engage in leasing activities to accomplish one or more objectives, such as: investing funds; facilitating the sale or use of the lessor's own manufactured product; retaining control of locations when it is desirable that the property be operated by others; and making available to others property operated by the lessor for profit. Some lessors engage in leasing primarily or solely as a method of investing funds; some financing institutions specialize in leasing. On the other hand, some lessors engage in leasing as incidental to entirely different and relatively more significant business operations. Leasing activities of many lessors have both financing and operating characteristics to some degree, and some lessors have leasing activities of both types.[1]

Accounting methods

4. There are two predominant methods in general use for allocating rental revenue and expenses over the accounting periods covered by a lease. These may be termed the "financing" and the "operating" methods.

5. *Financing method*—Under the financing method, the excess of aggregate rentals over the cost (reduced by estimated residual value at the termination of the lease) of the leased property is generally designed to compensate the lessor for the use of the funds invested. Since this excess is in the nature of interest, it is recognized as revenue during the term of the lease in decreasing amounts related to the declining balance of the unrecovered investment or, in other words, as an approximately level rate of return on funds not yet recovered. When rentals are level, this results in a decreasing percentage of each succeeding rental being accounted for as revenue and an increasing percentage as recovery of investment. This is comparable to the method followed by most lending institutions in accounting for level repayment plans.

6. *Operating method*—Under the operating method, aggregate rentals are reported as revenue over the life of the lease. The amount of revenue to be recognized in each accounting period will ordinarily be equivalent to the amount of rent receivable according to the provisions of the lease unless

[1] A comprehensive discussion of leasing will be found in Accounting Research Study No. 4. *Reporting of Leases in Financial Statements* by John H. Myers, published by the American Institute of Certified Public Accountants in 1962. (Accounting research studies are not statements of this Board or of the Institute, but are published for the purpose of stimulating discussion on important accounting issues.)

distortion of periodic revenue would result, e.g., when the rentals depart radically from a straight-line basis without relation to the economic usefulness of the leased property. The income statement reflects, as expenses, depreciation of the leased property, maintenance and other related costs, as well as the cost of any other services rendered under the provisions of the lease. The amount of these expenses to be recognized in each accounting period should be determined by methods which are appropriate in the circumstances and which are conventionally used for such expenses when incurred in activities other than leasing.

7. *Basis for selection*—The objective of fairly stating the lessor's net income during each of the periods covered by the leasing activities is the most important consideration in differentiating between the use of the financing or operating methods (see Paragraphs 13-15 for a description of balance sheet presentations consistent with the method used in determining income). Pertinent factors in making the choice, among others, are the following: the nature of the lessor's business activities; the specific objectives of its leasing activities, including the relationship to other business activities of the lessor, if any; the term of the lease in relation to the estimated useful life of the property; the existence of renewal or purchase options and the likelihood that the lessee will exercise them; provisions of the lease which indicate the extent to which the usual risks of ownership (e.g., obsolescence, unprofitable operation, unsatisfactory performance, idle capacity, dubious residual value) or rewards of ownership (e.g., profitable operation, gain from appreciation in value at end of lease) rest with the lessor or the lessee.

8. The financing method is generally appropriate for measuring periodic net income from leasing activities of entities engaged in, perhaps among other things, lending money at interest—e.g., lease-finance companies, banks, insurance companies or pension funds. Lease agreements of institutions of this kind typically are designed to pass all or most of the usual ownership risks or rewards to the lessee, and to assure the lessor of, and generally limit him to, a full recovery of his investment plus a reasonable return on the use of the funds invested, subject only to the credit risks generally associated with secured loans. Usually, the financing method is similar to the method of accounting for revenue already in use for other lending activities of the institutions. The financing method is also appropriate for a leasing activity of an entity which is not identified as a financial institution, such as a manufacturer, if the lease agreements have the characteristics described earlier in this paragraph.

9. On the other hand, there are companies (e.g., the owner-operator of an office building, the lessor of automotive equipment on short-term leases—daily, weekly or monthly) which retain the usual risks or rewards of ownership in connection with their leasing activity. They may also assume responsibilities for maintaining the leased property or furnishing certain related services which will give rise to costs to be incurred in the future. Rental revenues are designed to cover the costs of these services, depreciation and obsolescence, and to provide an adequate profit for assuming the risks involved. In these cases the operating method is appropriate for measuring periodic net income from leasing activities. The operating method is also appropriate if the leasing activity is an integral part of manufacturing, marketing or other operations of a business which generate revenues and costs which must be considered along with revenues and costs from the leasing activities in arriving at appropriate methods for measuring the overall periodic net income (examples are leases of retail outlets with lease provisions deliberately made favorable to induce lessee to handle lessor's product and leases which generate significant servicing revenues and costs). The operating method likewise is appropriate for leasing activities for an otherwise strictly financing institution if such activities are characterized as set forth in this paragraph.

OPINION

10. The Board believes that the financing method of accounting, described in Paragraph 5, should be used for lease financing activities of the type described in Paragraph 8. The Board believes that the operating method, described in Paragraph 6, should be used for leasing activities of the type described in Paragraph 9. If a single company engages in separate leasing activities of the types described in both Paragraphs 8 and 9, the appropriate accounting method should be used for each type of leasing activity. Where a single lease has both financing and operating characteristics to some degree, the determination of the appropriate accounting method should be made on the

basis of which of the two methods described in Paragraphs 5 and 6 will fairly reflect net income. In rare cases, a single lease may require the use of both methods to reflect fairly lessor's net income; a condition precedent to this would be the ability initially to assign aggregate rentals to each of the financing and operating elements.

Initial direct costs

11. When initial direct costs of negotiating and closing leases are reasonably expected to be recovered from revenues, these costs should preferably be deferred and allocated to future periods in which the related revenues are reported. In this context, "initial direct" costs are those costs which are directly associated with consummating the lease (e.g., commissions, legal fees, costs of investigating the lessee's financial status and of preparing and processing documents). The method of allocation to future periods should be consistent with that used to recognize revenue under the financing or operating methods. However, substantially the same net income would be reported under the financing method by expensing initial costs as incurred and recognizing as revenue in the same period, in addition to the normal revenue, a portion of the unearned revenue equal to the initial costs; this method is also acceptable. When initial direct costs of a lessor are reasonably constant in relation to revenues, no practical objection can be raised to a practice of consistently expensing these costs as incurred and recognizing revenue without compensating for initial costs.

Leasing by manufacturers

12. When manufacturers use leases to assist in marketing products or services, the Board believes that the guidelines described in Paragraphs 7, 8 and 9 indicate whether the financing or operating method is appropriate. Manufacturing revenues (amounts which would have been obtained in a regular sale or the discounted amount of future rentals whichever is lower), costs and profit should be determined at the time of entering into the lease and reported in the income statement of the lessor on the same basis as outright sales of similar manufactured property, provided all of these conditions are met: (a) credit risks are reasonably predictable, (b) the lessor does not retain sizable risks of ownership of the nature described in Paragraph 7 and (c) there are no important uncertainties surrounding the amount of costs yet to be incurred or revenues yet to be earned under the lease. If any of these conditions is not met, manufacturing profit should be recognized, using the operating method, only as realized in the form of rental revenue over the term of the lease. If manufacturing revenue is determined at the time of entering into the lease, the conditions described above having been met, the financing method should be used and the amount of the manufacturing revenue becomes the "cost of the leased property" as that term is used in Paragraph 5. When it is feasible to determine normal selling prices, then revenues, costs and trading profits of dealers and other middlemen should be recognized in the same manner and under the same conditions described above for manufacturers.

Reporting in balance sheet

13. Amounts invested in leasing activities which are significant in relation to other resources or activities should be stated separately in a manner which best describes the nature of the investment. The investment in leasing activities is neither a conventional loan or receivable, nor in the same category as facilities employed in typical manufacturing or commercial operations. The classification and description of the investment should be appropriate in the circumstances and should depend upon whether the financing or operating method of accounting is used.

14. When the financing method is used, the aggregate rentals called for in the lease should be classified with or near receivables and a description used along the lines of "receivables under contracts for equipment rentals" or "contracts receivable for equipment rentals." When a company is predominantly engaged in leasing activities for which the financing method is appropriate, information should be disclosed regarding future maturities of the rentals receivable. Unearned finance charges or interest (as defined in Paragraph 5) included in the aggregate rentals should be shown as a deduction therefrom.[3] Estimated residual value should be classified separately with or near property, plant and equipment unless the residual value represents an amount expected to be collected from the lessee (e.g., when a favorable purchase option exists), in which case it should be classified with or near notes and accounts

[3] See Paragraph 14 of Opinion No. 6 of the Accounting Principles Board.

receivable. Thus, the investment is represented by the net rentals receivable plus the residual value. Receivables under financing leases are subject to the same considerations as to current or noncurrent classification, where such segregation is appropriate in the balance sheet, as are assets resulting from other activities.[3]

15. When the operating method is used, the investment should be classified with or near property, plant and equipment and a description used along the lines of "investment in leased property," "property held for or under lease," or "property (equipment, buildings, machines, etc.) leased to others"; accumulated allowances for depreciation and obsolescence should be shown as a deduction from the investment.

Disclosure

16. In addition to an appropriate description in the balance sheet of the investment in property held for or under lease (see Paragraphs 13-15), the principal accounting methods used in accounting for leasing activities should be disclosed. Further, where leasing is a substantial portion of a nonfinancing institution's operations, the Board believes that financial statements should disclose sufficient information to enable readers to assess the significance of leasing activities to the company. Leases and leased property are also subject to the conventional disclosure requirements affecting financial statements as, for example, disclosure of pledges of leased property and leases as security for loans.

Income taxes

17. When lease revenues or expenses are recognized for tax purposes in a period other than the one in which they are recognized for financial reporting, appropriate consideration should be given to allocation of income taxes among accounting periods.

Relationship to APB Opinion No. 5

18. The Board takes notice of a question that has been raised as to whether certain conclusions herein are inconsistent with conclusions in Opinion No. 5, "Reporting of Leases in Financial Statements of Lessee"—specifically, the question is whether leases accounted for on the financing method by lessors should be capitalized by lessees. As indicated in Paragraphs 2 and 7, the Board considers the principal accounting problem of lessors to be the allocation of revenue and expense to accounting periods covered by the lease in a manner that meets the objective of fairly stating the lessor's net income; the Board believes that this objective can be met by application of the financing method when the circumstances are as described in the Opinion. As to the lessee, however, capitalization of leases, other than those which are in substance installment purchases of property, may not be necessary in order to state net income fairly since the amount of the lease rentals may represent a proper charge to income. There continues to be a question as to whether assets and the related obligations should be reflected in the balance sheet for leases other than those that are in substance installment purchases. The Board will continue to give consideration to this question.

Prior lease agreements

19. Unless otherwise stated, Opinions of the Board are not intended to be retroactive. However, the Board believes that the conclusions as to disclosure in Paragraphs 13-16 should apply to lease agreements made prior as well as subsequent to the issuance of this Opinion.

EFFECTIVE DATE OF THIS OPINION

20. Except as noted in Paragraph 19, this Opinion shall be effective for fiscal periods beginning after December 31, 1966. However, the Board encourages earlier application of the provisions of this Opinion where appropriate.

The Opinion entitled "Accounting for Leases in Financial Statements of Lessors" was adopted unanimously by the twenty-one members of the Board.

[3] See Chapter 3A of Accounting Research Bulletin No. 43.

NOTES

Opinions present the considered opinion of at least two-thirds of the members of the Accounting Principles Board, reached on a formal vote after examination of the subject matter.

Except as indicated in the succeeding paragraph, the authority of the Opinions rests upon their general acceptability. While it is recognized that general rules may be subject to exception, the burden of justifying departures from Board Opinions must be assumed by those who adopt other practices.

Action of Council of the Institute (Special Bulletin, Disclosure of Departures From Opinions of Accounting Principles Board, October 1964) *provides that:*

a. "Generally accepted accounting principles" are those principles which have substantial authoritative support.

b. Opinions of the Accounting Principles Board constitute "substantial authoritative support."

c. "Substantial authoritative support" can exist for accounting principles that differ from Opinions of the Accounting Principles Board.

The Council action also requires that departures from Board Opinions be disclosed in footnotes to the financial statements or in independent auditors' reports when the effect of the departure on the financial statements is material.

Unless otherwise stated, Opinions of the Board are not intended to be retroactive. They are not intended to be applicable to immaterial items.

APB Opinion No. 8

ACCOUNTING FOR THE COST OF PENSION PLANS

NOVEMBER, 1966

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INTRODUCTION

1. Pension plans have developed in an environment characterized by a complex array of social concepts and pressures, legal considerations, actuarial techniques, income tax laws and regulations, business philosophies, and accounting concepts and practices. Each plan reflects the interaction of the environment with the interests of the persons concerned with its design, interpretation and operation. From these factors have resulted widely divergent practices in accounting for the cost of pension plans.

2. An increased significance of pension cost in relation to the financial position and results of operations of many businesses has been brought about by the substantial growth of private pension plans, both in numbers of employees covered and in amounts of retirement benefits. The assets accumulated and the future benefits to employees under these plans have reached such magnitude that changes in actuarial assumptions concerning pension fund earnings, employee mortality and turnover, retirement age, etc., and the treatment of differences between such assumptions and actual experience, can have important effects on the pension cost recognized for accounting purposes from year to year.

3. In Accounting Research Bulletin No. 47, *Accounting for Costs of Pension Plans*, the committee on accounting procedure stated its preferences that "costs based on current and future services should be systematically accrued during the expected period of active service of the covered employees" and that "costs based on past services should be charged off over some reasonable period,

provided the allocation is made on a systematic and rational basis and does not cause distortion of the operating results in any one year." In recognition of the divergent views then existing, however, the committee also said "as a minimum, the accounts and financial statements should reflect accruals which equal the present worth, actuarially calculated, of pension commitments to employees to the extent that pension rights have vested in the employees, reduced, in the case of the balance sheet, by any accumulated trusteed funds or annuity contracts purchased." The committee did not explain what was meant by the term "vested" and did not make any recommendations concerning appropriate actuarial cost methods or recognition of actuarial gains and losses.

4. Despite the issuance of Accounting Research Bulletin No. 47, accounting for the cost of pension plans has varied widely among companies and has sometimes resulted in wide year-to-year fluctuations in the provisions for pension cost of a single company. Generally, companies have provided pension cost equivalent to the amounts paid to a pension fund or used to purchase annuities. In many cases such payments have included amortization of past service cost (and prior service cost arising on amendment of a plan) over periods ranging from about ten to forty years; in other cases the payments have not included amortization but have included an amount equivalent to interest (see definition of *interest* in the Glossary, Appendix B) on unfunded prior service cost. In some cases payments from year to year have varied with fluctuations in company earnings or with the availability of funds. In other cases payments have been affected by the Federal income tax rates in effect at a particular time. The recognition of actuarial gains and losses in the year of their determination, or intermittently, has also caused year-to-year variations in such payments.

5. Because of the increasing importance of pensions and the variations in accounting for them, the Accounting Principles Board authorized Accounting Research Study No. 8, *Accounting for the Cost of Pension Plans* (referred to hereinafter as the "Research Study"). The Research Study was published in May 1965 by the American Institute of Certified Public Accountants and has been widely distributed. The Board has carefully examined the recommendations of the Research Study and considered many comments and articles about it. The Board's conclusions agree in most respects with, but differ in some from, those in the Research Study.

6. The Board has concluded that this Opinion is needed to clarify the accounting principles and to narrow the practices applicable to accounting for the cost of pension plans. This Opinion supersedes Accounting Research Bulletin No. 43, Chapter 13, Section A, *Compensation: Pension Plans—Annuity Costs Based on Past Service* and Accounting Research Bulletin No. 47, *Accounting for Costs of Pension Plans.*

7. The computation of pension cost for accounting purposes requires the use of actuarial techniques and judgment. Generally pension cost should be determined from a study by an actuary, giving effect to the conclusions set forth in this Opinion. It should be noted that the actuarial cost methods and their application for accounting purposes may differ from those used for funding purposes. A discussion of actuarial valuations, assumptions and cost methods is included in Appendix A. The terminology used in this Opinion to describe pension cost and actuarial cost methods is consistent with that generally used by actuaries and others concerned with pension plans. A Glossary of such terminology is included in Appendix B.

PENSION PLANS COVERED BY THIS OPINION

8. For the purposes of this Opinion, a pension plan is an arrangement whereby a company undertakes to provide its retired employees with benefits that can be determined or estimated in advance from the provisions of a document or documents or from the company's practices. Ordinarily, such benefits are monthly pension payments but, in many instances, they include death and disability payments. However, death and disability payments under a separate arrangement are not considered in this Opinion. The Opinion applies both to written plans and to plans whose existence may be implied from a well-defined, although perhaps unwritten, company policy. A company's practice of paying retirement benefits to selected employees in amounts determined on a case-by-case basis at or after retirement does not constitute a pension plan under this Opinion. The Opinion applies to pension cost incurred outside the United States

under plans that are reasonably similar to those contemplated by this Opinion, when included in financial statements intended to conform with generally accepted accounting principles in the United States. The Opinion applies to unfunded plans as well as to insured plans and trust fund plans. It applies to defined-contribution plans as well as to defined-benefit plans. It applies also to deferred compensation contracts with individual employees if such contracts, taken together, are equivalent to a pension plan. It does not apply to deferred profit-sharing plans except to the extent that such a plan is, or is part of, an arrangement that is in substance a pension plan.

BASIC ACCOUNTING METHOD

Discussion

9. This Opinion is concerned with the determination of the amount of pension cost for accounting purposes. In considering the discussions and conclusions in this Opinion, it is important to keep in mind that the annual pension cost to be charged to expense ("the provision for pension cost") is not necessarily the same as the amount to be funded for the year. The determination of the amount to be funded is a financial matter not within the purview of this Opinion.

10. The pension obligations assumed by some companies are different from those assumed by other companies. In some plans the company assumes direct responsibility for the payment of benefits described in the plan. In these cases, if the pension fund is inadequate to pay the benefits to which employees are entitled, the company is liable for the deficiency. In contrast, the terms of most funded plans limit the company's legal obligation for the payment of benefits to the amounts in the pension fund. In these cases, if the pension fund is inadequate to pay the benefits to which employees are otherwise entitled, such benefits are reduced in a manner stated in the plan and the company has no further legal obligation.

11. There is broad agreement that pension cost, including related administrative expense, should be accounted for on the accrual basis. There is not general agreement, however, about the nature of pension cost. Some view pensions solely as a form of supplemental benefit to employees in service at a particular time. Others see a broader purpose in pensions; they consider pensions to be in large part (a) a means of promoting efficiency by providing for the systematic retirement of older employees or (b) the fulfillment of a social obligation expected of business enterprises, the cost of which, as a practical matter, constitutes a business expense that must be incurred. Those who hold this second viewpoint associate pension cost, to a large extent, with the plan itself rather than with specific employees. In addition, the long-range nature of pensions causes significant uncertainties about the total amount of pension benefits ultimately to be paid and the amount of cost to be recognized. These differences in viewpoint concerning the nature of pension cost, the uncertainties regarding the amount of the estimates, and the use of many actuarial approaches, compound the difficulty in reaching agreement on the total amount of pension cost over a long period of years and on the time to recognize any particular portion applicable to an employee or group of employees. It is only natural, therefore, that different views exist concerning the preferable way to recognize pension cost. The major views are described in the following four paragraphs.

12. One view is that periodic pension cost should be provided on an actuarial basis that takes into account all estimated prospective benefit payments under a plan with respect to the existing employee group, whether such payments relate to employee service rendered before or after the plan's adoption or amendment, and that no portion of the provision for such payments should be indefinitely deferred or treated as though, in fact, it did not exist. Those holding this view believe that the recurring omission of a portion of the provision, because of the time lag between making the provision and the subsequent benefit payments under a plan, is a failure to give accrual accounting recognition to the cost applicable to the benefits accrued over the service lives of all employees. Among those holding this view there is general agreement that cost relating to service following the adoption or amendment of a plan should be recognized ratably over the remaining service lives of employees. There is some difference of opinion, however, concerning the period of time to use in allocating that portion of the cost which the computations under some actuarial methods assign to employee service rendered before a plan's adoption or amendment. As to this cost, (a) those viewing pensions as relating solely to the existing employee group believe that it should be accounted for over the remaining service

lives of those in the employ of the company at the time of the plan's adoption or amendment, whereas (b) some of those holding the broader view of pensions, referred to in Paragraph 11, believe that this cost is associated to a large extent with the plan itself and hence that the period of providing for it need not be limited to the remaining service lives of a particular group of employees but may be extended somewhat beyond that period. However, this difference of opinion relates only to the period of time over which such cost should be provided.

13. An opposing view stresses that pension cost is related to the pension benefits to be paid to the continuing employee group as a whole. Those holding this view emphasize that, in the application of accrual accounting, charges against income must be based on actual transactions and events—past, present or reasonably anticipated. They stress the long-range nature of pensions, referred to in Paragraph 11, and emphasize the uncertainties concerning the total cost of future benefits. They point out that, in the great majority of cases, provision for normal cost plus an amount equivalent to interest on unfunded prior service cost will be adequate to meet, on a continuing basis, all benefit payments under a plan. Those holding this view believe that following the view expressed in Paragraph 12 can result, over a period of years, in charging income with, and recording a balance-sheet accrual for, amounts that will not be paid as benefits. They see no reason therefore to urge employers to provide more than normal cost plus an amount equivalent to interest on unfunded prior service cost in these circumstances, because additional amounts never expected to be paid by a going concern are not corporate costs, and thus are not appropriate charges against income. They acknowledge, however, that corporations can and do make payments to pension funds for past and prior service cost, with the result that reductions will be effected in future charges for the equivalent of interest on unfunded amounts, but they consider this to be solely a matter of financial management rather than a practice dictated by accounting considerations.

14. In many pension plans, cost recorded on the basis described in Paragraph 13 will accumulate an amount (whether funded or not) at least equal to the actuarially computed value of vested benefits (see definition of *vested benefits* in the Glossary, Appendix B). However, this result might not be achieved in some cases (for example, if the average age of the employee group is high in relation to that of expected future employee groups, or if benefits vest at a relatively early age). Some hold the view that when periodic provisions are based on normal cost plus an amount equivalent to interest such periodic provisions should be increased if they will not, within a reasonable period of time, accumulate an amount (whether funded or not) at least equal to the actuarially computed value of vested benefits. Others would require the increases in provisions only if the company has a legal obligation for the payment of such benefits.

15. Another view is that, if the company has no responsibility for paying benefits beyond the amounts in the pension fund, pension cost is discretionary and should be provided for a particular accounting period only when the company has made or has indicated its intent to make a contribution to the pension fund for the period. Others believe that pension cost is discretionary even if the company has a direct responsibility for the payment of benefits described in the plan.

Opinion

16. The Board recognizes that a company may limit its legal obligation by specifying that pensions shall be payable only to the extent of the assets in the pension fund. Experience shows, however, that with rare exceptions pension plans continue indefinitely and that termination and other limitations of the liability of the company are not invoked while the company continues in business. Consequently, the Board believes that, in the absence of convincing evidence that the company will reduce or discontinue the benefits called for in a pension plan, the cost of the plan should be accounted for on the assumption that the company will continue to provide such benefits. This assumption implies a long-term undertaking, the cost of which should be recognized annually whether or not funded. Therefore, accounting for pension cost should not be discretionary.

17. All members of the Board believe that the entire cost of benefit payments ultimately to be made should be charged against income subsequent to the adoption or amendment of a plan and that no portion of such cost should be charged directly against retained earnings. Differences of opinion exist concerning the measure of the cost of such ultimate payments. The Board believes that the approach stated in Paragraph 12 is preferable for measuring the cost of benefit pay-

ments ultimately to be made. However, some members of the Board believe that the approach stated in Paragraph 13, in some cases with the modifications described in Paragraph 14, is more appropriate for such measurement. The Board has concluded, in the light of such differences in views and of the fact that accounting for pension cost is in a transitional stage, that the range of practices would be significantly narrowed if pension cost were accounted for at the present time within limits based on Paragraphs 12, 13 and 14. Accordingly, the Board believes that the annual provision for pension cost should be based on an accounting method that uses an acceptable actuarial cost method (as defined in Paragraphs 23 and 24) and results in a provision between the minimum and maximum stated below. The accounting method and the actuarial cost method should be consistently applied from year to year.

a. *Minimum.* The annual provision for pension cost should not be less than the total of (1) normal cost, (2) an amount equivalent to interest on any unfunded prior service cost and (3) if indicated in the following sentence, a provision for vested benefits. A provision for vested benefits should be made if there is an excess of the actuarially computed value of vested benefits (see definition of *vested benefits* in the Glossary, Appendix B) [1] over the total of (1) the pension fund and (2) any balance-sheet pension accruals, less (3) any balance-sheet pension prepayments or deferred charges, at the end of the year, and such excess is not at least 5 per cent less than the comparable excess at the beginning of the year. The provision for vested benefits should be the lesser of (A) the amount, if any, by which 5 per cent of such excess at the beginning of the year is more than the amount of the reduction, if any, in such excess during the year or (B) the amount necessary to make the aggregate annual provision for pension cost equal to the total of (1) normal cost, (2) an amount equivalent to amortization, on a 40-year basis, of the past service cost (unless fully amortized), (3) amounts equivalent to amortization, on a 40-year basis, of the amounts of any increases or decreases in prior service cost arising on amendments of the plan (unless fully amortized) and (4) interest equivalents under Paragraph 42 or 43 on the difference between provisions and amounts funded.[2]

b. *Maximum.* The annual provision for pension cost should not be greater than the total of (1) normal cost, (2) 10 per cent of the past service cost (until fully amortized), (3) 10 per cent of the amounts of any increases or decreases in prior service cost arising on amendments of the plan (until fully amortized) and (4) interest equivalents under Paragraph 42 or 43 on the difference between provisions and amounts funded. The 10 per cent limitation is considered necessary to prevent unreasonably large charges against income during a short period of years.

18. The difference between the amount which has been charged against income and the amount which has been paid should be shown in the balance sheet as accrued or prepaid pension cost. If the company has a legal obligation for pension cost in excess of amounts paid or accrued, the excess should be shown in the balance sheet as both a liability and a deferred charge. Except to the extent indicated in the preceding sentences of this paragraph, unfunded prior service cost is not a liability which should be shown in the balance sheet.

ACTUARIAL COST METHODS

Discussion

19. A number of actuarial cost methods have been developed to determine pension cost. These methods are designed primarily as funding techniques, but many of them are also useful in determining pension cost for accounting purposes. Pension cost can vary significantly, depending on the actuarial cost method selected; furthermore, there are many variations in the application of the methods, in the necessary actuarial assumptions concerning employee turnover, mortality, compensation levels, pension fund earnings, etc., and in the treatment of actuarial gains and losses.

20. The principal actuarial cost methods currently in use are described in Appendix A. These methods include an accrued benefit cost method and several projected benefit cost methods.

a. Under the accrued benefit cost method (unit credit method), the amount assigned

[1] The actuarially computed value of vested benefits would ordinarily be based on the actuarial valuation used for the year even though such valuation would usually be as of a date other than the balance sheet date.

[2] For purposes of this sentence, amortization should be computed as a level annual amount, including the equivalent of interest.

to the current year usually represents the present value of the increase in present employees' retirement benefits resulting from that year's service. For an individual employee, this method results in an increasing cost from year to year because both the present value of the annual increment in benefits and the probability of reaching retirement increase as the period to retirement shortens; also, in some plans, the retirement benefits are related to salary levels, which usually increase during the years. However, the aggregate cost for a total work force of constant size tends to increase only if the average age or average compensation of the entire work force increases.

b. Under the projected benefit cost methods (entry age normal, individual level premium, aggregate and attained age normal methods), the amount assigned to the current year usually represents the level amount (or an amount based on a computed level percentage of compensation) that will provide for the estimated projected retirement benefits over the service lives of either the individual employees or the employee group, depending on the method selected. Cost computed under the projected benefit cost methods tends to be stable or to decline year by year, depending on the method selected. Cost computed under the entry age normal method is usually more stable than cost computed under any other method.

21. Some actuarial cost methods (individual level premium and aggregate methods) assign to subsequent years the cost arising at the adoption or amendment of a plan. Other methods (unit credit, entry age normal and attained age normal methods) assign a portion of the cost to years prior to the adoption or amendment of a plan, and assign the remainder to subsequent years. The portion of cost assigned to each subsequent year is called *normal cost.* At the adoption of a plan, the portion of cost assigned to prior years is called *past service cost.* At any later valuation date, the portion of cost assigned to prior years (which includes any remaining past service cost) is called *prior service cost.* The amount assigned as past or prior service cost and the amount assigned as normal cost vary depending on the actuarial cost method. The actuarial assignment of cost between past or prior service cost and normal cost is not indicative of the periods in which such cost should be recognized for accounting purposes.

22. In some cases, past service cost (and prior service cost arising on amendment of a plan) is funded in total; in others it is funded in part; in still others it is not funded at all. In practice, the funding of such cost is influenced by the Federal income tax laws and related regulations, which generally limit the annual deduction for such cost to 10 per cent of the initial amount. There is no tax requirement that such cost be funded, but there are requirements that effectively prohibit the unfunded cost from exceeding the total of past service cost and prior service cost arising on amendment of the plan. The practical effect of the tax requirements is that on a cumulative basis normal cost plus an amount equivalent to the interest on any unfunded prior service cost must be funded. Funding of additional amounts is therefore discretionary for income tax purposes. However, neither funding nor the income tax laws and related regulations are controlling for accounting purposes.

Opinion

23. To be acceptable for determining cost for accounting purposes, an actuarial cost method should be rational and systematic and should be consistently applied so that it results in a reasonable measure of pension cost from year to year. Therefore, in applying an actuarial cost method that separately assigns a portion of cost as past or prior service cost, any amortization of such portion should be based on a rational and systematic plan and generally should result in reasonably stable annual amounts. The equivalent of interest on the unfunded portion may be stated separately or it may be included in the amortization; however, the total amount charged against income in any one year should not exceed the maximum amount described in Paragraph 17.

24. Each of the actuarial cost methods described in Appendix A, except terminal funding, is considered acceptable when the actuarial assumptions are reasonable and when the method is applied in conformity with the other conclusions of this Opinion. The terminal funding method is not acceptable because it does not recognize pension cost prior to retirement of employees. For the same reason, the pay-as-you-go method (which is not an actuarial cost method) is not acceptable. The acceptability of methods not discussed herein should be determined from the guidelines in this and the preceding paragraph.

ACTUARIAL GAINS AND LOSSES

Discussion

25. Actuarial assumptions necessarily are based on estimates of future events. Actual events seldom coincide with events estimated; also, as conditions change, the assumptions concerning the future may become invalid. Adjustments may be needed annually therefore to reflect actual experience, and from time to time to revise the actuarial assumptions to be used in the future. These adjustments constitute actuarial gains and losses. They may be regularly recurring (for example, minor deviations between experience and actuarial assumptions) or they may be unusual or recurring at irregular intervals (for example, substantial investment gains or losses, changes in the actuarial assumptions, plant closings, etc.).

26. In dealing with actuarial gains and losses, the primary question concerns the timing of their recognition in providing for pension cost. In practice, three methods are in use; immediate-recognition, spreading and averaging. Under the immediate-recognition method (not ordinarily used at present for net losses), net gains are applied to reduce pension cost in the year of occurrence or the following year. Under the spreading method, net gains or losses are applied to current and future cost, either through the normal cost or through the past service cost (or prior service cost on amendment). Under the averaging method, an average of annual net gains and losses, developed from those that occurred in the past with consideration of those expected to occur in the future, is applied to the normal cost.

27. The use of the immediate-recognition method sometimes results in substantial reductions in, or the complete elimination of, pension cost for one or more years. For Federal income tax purposes, when the unit credit actuarial cost method is used, and in certain other instances, actuarial gains reduce the maximum pension-cost deduction for the year of occurrence or the following year.

28. Unrealized appreciation and depreciation in the value of investments in a pension fund are forms of actuarial gains and losses. Despite short-term market fluctuations, the overall rise in the value of equity investments in recent years has resulted in the investments of pension funds generally showing net appreciation. Although appreciation is not generally recognized at present in providing for pension cost, it is sometimes recognized through the interest assumption or by introducing an assumed annual rate of appreciation as a separate actuarial assumption. In other cases, appreciation is combined with other actuarial gains and losses and applied on the immediate-recognition, spreading or averaging method.

29. The amount of any unrealized appreciation to be recognized should also be considered. Some actuarial valuations recognize the full market value. Others recognize only a portion (such as 75 per cent) of the market value or use a moving average (such as a five-year average) to minimize the effects of short-term market fluctuations. Another method used to minimize such fluctuations is to recognize appreciation annually based on an expected long-range growth rate (such as 3 per cent) applied to the cost (adjusted for appreciation previously so recognized) of common stocks; when this method is used, the total of cost and recognized appreciation usually is not permitted to exceed a specified percentage (such as 75 per cent) of the market value. Unrealized depreciation is recognized in full or on a basis similar to that used for unrealized appreciation.

Opinion

30. The Board believes that actuarial gains and losses, including realized investment gains and losses, should be given effect in the provision for pension cost in a consistent manner that reflects the long-range nature of pension cost. Accordingly, except as otherwise indicated in Paragraphs 31 and 33, actuarial gains and losses should be spread over the current year and future years or recognized on the basis of an average as described in Paragraph 26. If this is not accomplished through the routine application of the method (for example, the unit credit method—see Paragraph 27), the spreading or averaging should be accomplished by separate adjustments of the normal cost resulting from the routine application of the method. Where spreading is accomplished by separate adjustments, the Board considers a period of from 10 to 20 years to be reasonable. Alternatively, an effect similar to spreading or averaging may be obtained by applying net actuarial gains as a reduction of prior service cost in a manner that reduces the annual amount equivalent to interest on, or the annual amount of amortization of, such prior service cost, and does not reduce the period of amortization.

31. Actuarial gains and losses should be recognized immediately if they arise from a single occurrence not directly related to the operation of the pension plan and not in the ordinary course of the employer's business. An example of such occurrences is a plant closing, in which case the actuarial gain or loss should be treated as an adjustment of the net gain or loss from that occurrence and not as an adjustment of pension cost for the year. Another example of such occurrences is a merger or acquisition accounted for as a purchase, in which case the actuarial gain or loss should be treated as an adjustment of the purchase price. However, if the transaction is accounted for as a pooling of interests, the actuarial gain or loss should generally be treated as described in Paragraph 30.

32. The Board believes unrealized appreciation and depreciation should be recognized in the determination of the provision for pension cost on a rational and systematic basis that avoids giving undue weight to short-term market fluctuations (as by using a method similar to those referred to in Paragraph 29). Such recognition should be given either in the actuarial assumptions or as described in Paragraph 30 for other actuarial gains and losses. Ordinarily appreciation and depreciation need not be recognized for debt securities expected to be held to maturity and redeemed at face value.

33. Under variable annuity and similar plans the retirement benefits vary with changes in the value of a specified portfolio of equity investments. In these cases, investment gains or losses, whether realized or unrealized, should be recognized in computing pension cost only to the extent that they will not be applied in determining retirement benefits.

EMPLOYEES INCLUDED IN COST CALCULATIONS

Discussion

34. Under some plans employees become eligible for coverage when they are employed; other plans have requirements of age or length of service or both. Some plans state only the conditions an employee must meet to receive benefits but do not otherwise deal with coverage. Ordinarily actuarial valuations exclude employees likely to leave the company within a short time after employment. This simplifies the actuarial calculations. Accordingly, actuarial calculations ordinarily exclude employees on the basis of eligibility requirements and, in some cases, exclude covered employees during the early years of service.

35. If provisions are not made for employees from the date of employment, pension cost may be understated. On the other hand, the effect of including all employees would be partially offset by an increase in the turnover assumption; therefore, the inclusion of employees during early years of service may expand the volume of the calculations without significantly changing the provisions for pension cost.

Opinion

36. The Board believes that all employees who may reasonably be expected to receive benefits under a pension plan should be included in the cost calculations, giving appropriate recognition to anticipated turnover. As a practical matter, however, when the effect of exclusion is not material it is appropriate to omit certain employees from the calculations.

COMPANIES WITH MORE THAN ONE PLAN

Opinion

37. A company that has more than one pension plan need not use the same actuarial cost method for each one; however, the accounting for each plan should conform to this Opinion. If a company has two or more plans covering substantial portions of the same employee classes and if the assets in any of the plans ultimately can be used in paying present or future benefits of another plan or plans, such plans may be treated as one plan for purposes of determining pension cost.

DEFINED-CONTRIBUTION PLANS

Opinion

38. Some defined-contribution plans state that contributions will be made in accordance with a specified formula and that benefit payments will be based on the amounts accumulated from such contributions. For such a plan the contribution applicable to a particular year should be the pension cost for that year.

39. Some defined-contribution plans have defined benefits. In these circumstances, the plan requires careful analysis. When the substance of the plan is to provide the defined benefits, the annual pension cost should be determined in accordance with the conclusions of this Opinion applicable to defined-benefit plans.

INSURED PLANS

Opinion

40. Insured plans are forms of funding arrangements and their use should not affect the accounting principles applicable to the determination of pension cost. Cost under individual policy plans is ordinarily determined by the individual level premium method, and cost under group deferred annuity contracts is ordinarily determined by the unit credit method. Cost under deposit administration contracts, which operate similarly to trust-fund plans, may be determined on any of several methods. Some elements of pension cost, such as the application of actuarial gains (dividends, termination credits, etc.), may at times cause differences between the amounts being paid to the insurance company and the cost being recognized for accounting purposes. The Board believes that pension cost under insured plans should be determined in conformity with the conclusions of this Opinion.

41. Individual annuity or life insurance policies and group deferred annuity contracts are often used for plans covering small employee groups. Employers using one of these forms of funding exclusively do not ordinarily have ready access to actuarial advice in determining pension cost. Three factors to be considered in deciding whether the amount of net premiums paid is the appropriate charge to expense are dividends, termination credits and pension cost for employees not yet covered under the plan. Usually, the procedures adopted by insurance companies in arriving at the amount of dividends meet the requirements of Paragraph 30; consequently, in the absence of wide year-to-year fluctuations such dividends should be recognized in the year credited. Termination credits should be spread or averaged in accordance with Paragraph 30. Unless the period from date of employment to date of coverage under the plan is so long as to have a material effect on pension cost, no provision need be made for employees expected to become covered under the plan. If such a provision is made, it need not necessarily be based on the application of an actuarial cost method.

EFFECT OF FUNDING

Opinion

42. This Opinion is written primarily in terms of pension plans that are funded. The accounting described applies also to plans that are unfunded. In unfunded plans, pension cost should be determined under an acceptable actuarial cost method in the same manner as for funded plans; however, because there is no fund to earn the assumed rate of interest, the pension-cost provision for the current year should be increased by an amount equivalent to the interest that would have been earned in the current year if the prior-year provisions had been funded.

43. For funded plans, the amount of the pension cost determined under this Opinion may vary from the amount funded. When this occurs, the pension-cost provision for the year should be increased by an amount equivalent to interest on the prior-year provisions not funded or be decreased by an amount equivalent to interest on prior-year funding in excess of provisions.

44. A pension plan may become overfunded (that is, have fund assets in excess of all prior service cost assigned under the actuarial method in use for accounting purposes) as a result of contributions or as a result of actuarial gains. In determining provisions for pension cost, the effects of such overfunding are appropriately recognized in the current and future years through the operation of Paragraph 30 or 43. As to a plan that is overfunded on the effective date of this Opinion see Paragraph 48.

INCOME TAXES

Opinion

45. When pension cost is recognized for tax purposes in a period other than the one in which recognized for financial reporting, appropriate consideration should be given to allocation of income taxes among accounting periods.

DISCLOSURE

Opinion

46. The Board believes that pension plans are of sufficient importance to an understanding of financial position and results of operations that the following disclosures should be made in financial statements or their notes:

1. A statement that such plans exist, identifying or describing the employee groups covered.
2. A statement of the company's accounting and funding policies.
3. The provision for pension cost for the period.
4. The excess, if any, of the actuarially computed value of vested benefits over the total of the pension fund and any balance-sheet pension accruals, less any pension prepayments or deferred charges.
5. Nature and effect of significant matters affecting comparability for all periods presented, such as changes in accounting methods (actuarial cost method, amortization of past and prior service cost, treatment of actuarial gains and losses, etc.), changes in circumstances (actuarial assumptions, etc.), or adoption or amendment of a plan.

An example of what the Board considers to be appropriate disclosure is as follows:

> The company and its subsidiaries have several pension plans covering substantially all of their employees, including certain employees in foreign countries. The total pension expense for the year was $............, which includes, as to certain of the plans, amortization of prior service cost over periods ranging from 25 to 40 years. The company's policy is to fund pension cost accrued. The actuarially computed value of vested benefits for all plans as of December 31, 19...., exceeded the total of the pension fund and balance-sheet accruals less pension prepayments and deferred charges by approximately $.......... A change during the year in the actuarial cost method used in computing pension cost had the effect of reducing net income for the year by approximately $............

CHANGES IN ACCOUNTING METHOD

Opinion

47. On occasion a company may change its method of accounting for pension cost from one acceptable method under this Opinion to another. Such a change might be a change in the actuarial cost method, in the amortization of past and prior service cost, in the treatment of actuarial gains and losses, or in other factors. When such a change is made subsequent to the effective date of this Opinion, a question arises about the accounting for the difference between the cost actually provided under the old method and the cost that would have been provided under the new method. The Board believes that pension cost provided under an acceptable method of accounting in prior periods should not be changed subsequently. Therefore, the effect on prior-year cost of a change in accounting method should be applied prospectively to the cost of the current year and future years, in a manner consistent with the conclusions of this Opinion, and not retroactively as an adjustment of retained earnings or otherwise. The change and its effect should be disclosed as indicated in Paragraph 46.

TRANSITION TO RECOMMENDED PRACTICES

Opinion

48. For purposes of this Opinion, any unamortized prior service cost (computed under the actuarial cost method to be used for accounting purposes in the future) on the effective date of this Opinion may be treated as though it arose from an amendment of the plan on that date rather than

on the actual dates of adoption or amendment of the plan. If the pension plan is overfunded (see Paragraph 44) on the effective date of this Opinion, the amount by which it is overfunded (computed under the actuarial cost method to be used for accounting purposes in the future) should be treated as an actuarial gain realized on that date and should be accounted for as described in Paragraph 30.

49. The effect of any changes in accounting methods made as a result of the issuance of this Opinion should be applied prospectively to the cost of the current year and future years in a manner consistent with the conclusions of this Opinion, and not retroactively by an adjustment of retained earnings or otherwise. The change and its effect should be disclosed as indicated in Paragraph 46.

EFFECTIVE DATE

50. This Opinion shall be effective for fiscal periods beginning after December 31, 1966. However, where feasible the Board urges earlier compliance with this Opinion.

The Opinion entitled "Accounting for the Cost of Pension Plans" was adopted unanimously by the twenty members of the Board.

NOTES

Opinions present the considered opinion of at least two-thirds of the members of the Accounting Principles Board, reached on a formal vote after examination of the subject matter.

Except as indicated in the succeeding paragraph, the authority of the Opinions rests upon their general acceptability. While it is recognized that general rules may be subject to exception, the burden of justifying departures from Board Opinions must be assumed by those who adopt other practices.

Action of Council of the Institute (Special Bulletin, Disclosure of Departures From Opinions of Accounting Principles Board, *October 1964) provides that:*

a. *"Generally accepted accounting principles" are those principles which have substantial authoritative support.*
b. *Opinions of the Accounting Principles Board constitute "substantial authoritative support."*
c. *"Substantial authoritative support" can exist for accounting principles that differ from Opinions of the Accounting Principles Board.*

The Council action also requires that departures from Board Opinions be disclosed in footnotes to the financial statements or in independent auditors' reports when the effect of the departure on the financial statements is material.

Unless otherwise stated, Opinions of the Board are not intended to be retroactive. They are not intended to be applicable to immaterial items.

APPENDIX A—ACTUARIAL VALUATIONS, ASSUMPTIONS AND COST METHODS

Actuarial Valuations

An actuarial valuation of a pension plan is the process used by actuaries for determining the amounts an employer is to contribute (pay, fund) under a pension plan (except where an insured arrangement calls

Note: For further discussion see Appendix C of Accounting Research Study No. 8, *Accounting for the Cost of Pension Plans* by Ernest L. Hicks, CPA, published by the American Institute of Certified Public Accountants in 1965.

for payment of specified premiums). A valuation is made as of a specific date, which need not coincide with the end of the period for which a payment based on the valuation will be made. Indeed, it is uncommon for such a coincidence of dates to exist. Among other factors, a time lag is necessary in order to compile the data and to permit the actuary to make the necessary calculations. Although annual valuations are, perhaps, the rule, some employers have valuations made at less frequent intervals, in some cases as infrequently as every five years. The calculations are made for a closed group—ordinarily, employees presently covered by the plan, former employees having vested rights and retired employees currently receiving benefits.

An initial step in making a valuation is to determine the present value on the valuation date of benefits to be paid over varying periods of time in the future to employees after retirement (plus any other benefits under the plan). An actuarial cost method (see description in a later section of this Appendix) is then applied to this present value to determine the contributions to be made by the employer.

The resulting determinations are estimates, since in making a valuation a number of significant uncertainties concerning future events must be resolved by making several actuarial assumptions.

Actuarial Assumptions

The uncertainties in estimating the cost of a pension plan relate to (1) interest (return on funds invested), (2) expenses of administration and (3) the amounts and timing of benefits to be paid with respect to presently retired employees, former employees whose benefits have vested and present employees.

Interest (Return on Funds Invested)

The rate of interest used in an actuarial valuation is an expression of the average rate of earnings that can be expected on the funds invested or to be invested to provide for the future benefits. Since in most instances the investments include equity securities as well as debt securities, the earnings include dividends as well as interest; gains and losses on investments are also a factor. For simplicity, however, the rate is ordinarily called the interest rate.

Expenses of Administration

In many instances the expenses of administering a pension plan—for example, fees of attorneys, actuaries and trustees, and the cost of keeping pension records—are borne directly by the employer. In other cases, such expenses, or some of them, are paid by a trust or insurance company from funds contributed by the employer. In the latter cases, expenses to be incurred in the future must be estimated in computing the employer's pension cost.

Benefits

Several assumptions must be made as to the amounts and timing of the future benefits whose present value is used in expressing the cost of a pension plan. The principal assumptions are as follows:

a. *Future compensation levels.* Benefits under some pension plans depend in part on future compensation levels. Under plans of this type, an estimate is ordinarily made of normal increases expected from the progression of employees through the various earnings-rate categories, based on the employer's experience. General earnings-level increases, such as those which may result from inflation, are usually excluded from this actuarial assumption.

b. *Cost-of-living.* To protect the purchasing power of retirement benefits, some plans provide that the benefits otherwise determined will be adjusted from time to time to reflect variations in a specific index, such as the Consumer Price Index of the United States Bureau of Labor Statistics. In estimating the cost of such a plan, expected future changes in the cost-of-living index may be included in the actuarial assumptions.

c. *Mortality.* The length of time an employee covered by a pension plan will live is an important factor in estimating the cost of the benefit payments he will receive. If an employee dies before he becomes eligible for pension benefits, he receives no payments, although in some plans his beneficiaries receive lump-sum or periodic benefits. The total amount of pension benefits for employees who reach retirement is determined in large part by how long they live thereafter. Estimates regarding mortality are based on mortality tables.

d. *Retirement age.* Most plans provide a normal retirement age, but many plans permit employees to work thereafter under certain conditions. Some plans provide for retirement in advance of the normal age in case of disability, and most plans permit early retirement at the employee's option under certain conditions. When there are such provisions, an estimate is made of their effect on the amount and timing of the benefits which will ultimately be paid.

e. *Turnover.* In many plans, some employees who leave employment with the employer before completing vesting requirements forfeit their rights to receive benefits. In estimating the amount of future benefits, an allowance for the effect of turnover may be made.

f. *Vesting.* Many plans provide that after a stated number of years of service an employee becomes entitled to receive benefits (commencing at his normal retirement age and usually varying in amount with his number of years of service) even though he leaves the company for a reason other than retirement. This is taken into consideration in estimating the effect of turnover.

g. *Social security benefits.* For plans providing for a reduction of pensions by all or part of social security benefits, it is necessary in estimating future pension benefits to estimate the effect of future social security benefits. Ordinarily, this estimate is based on the assumption that such benefits will remain at the level in effect at the time the valuation is being made.

Actuarial Gains and Losses

The likelihood that actual events will coincide with each of the assumptions used is so remote as to constitute an impossibility. As a result, the actuarial assumptions used may be changed from time to time as experience and judgment dictate. In addition, whether or not the assumptions as to events in the future are changed, it is often necessary to recognize in the calculations the effect of differences between actual prior experience and the assumptions used in the past.

Actuarial Cost Methods

Actuarial cost methods have been developed by actuaries as funding techniques to be used in actuarial valuations. As indicated in Paragraph 19 of the accompanying Opinion, many of the actuarial cost methods are also useful for accounting purposes. The following discussion of the principal methods describes them as funding techniques (to simplify the discussion, references to prior service cost arising on amendment of a plan have been omitted; such cost would ordinarily be treated in a manner consistent with that described for past service cost). Their application for accounting purposes is described in the accompanying Opinion.

Accrued Benefit Cost Method—Unit Credit Method

Under the unit credit method, future service benefits (pension benefits based on service after the inception of a plan) are funded as they accrue—that is, as each employee works out the service period involved. Thus, the normal cost under this method for a particular year is the present value of the units of future benefit credited to employees for service in that year (hence unit credit). For example, if a plan provides benefits of $5 per month for each year of credited service, the normal cost for a particular employee for a particular year is the present value (adjusted for mortality and usually for turnover) of an annuity of $5 per month beginning at the employee's anticipated retirement date and continuing throughout his life.

The past service cost under the unit credit method is the present value at the plan's inception date of the units of future benefit credited to employees for service prior to the inception date.

The annual contribution under the unit credit method ordinarily comprises (1) the normal cost and (2) an amount for past service cost. The latter may comprise only an amount equivalent to interest on the unfunded balance or may also include an amount intended to reduce the unfunded balance.

As to an individual employee, the annual normal cost for an equal unit of benefit each year increases because the period to the employee's retirement continually shortens and the probability of reaching retirement increases; also, in some plans, the retirement benefits are related to salary levels, which usually increase during the years. As to the employees collectively, however, the step-up effect is masked, since older employees generating the highest annual cost are continually replaced by new employees generating the lowest. For a mature employee group, the normal cost would tend to be the same each year.

The unit credit method is almost always used when the funding instrument is a group annuity contract and may also be used in trusteed plans and deposit administration contracts where the benefit is a stated amount per year of service. This method is not frequently used where the benefit is a fixed amount (for example, $100 per month) or where the current year's benefit is based on earnings of a future period.

Projected Benefit Cost Methods

As explained above, the accrued benefit cost method (unit credit method) recognizes the cost of benefits only when they have accrued (in the limited sense that the employee service on which benefits are based has been rendered). By contrast, the projected benefit cost methods look forward. That is, they assign the entire cost of an employee's *projected* benefits to past, present and future periods. This is done in a manner not directly related to the periods during which the service on which the benefits are based has been or will be rendered. The principal projected benefit cost methods are discussed below.

a. *Entry age normal method.* Under the entry age normal method, the normal costs are computed on the assumption (1) that every employee entered the plan (thus, entry age) at the time of employment or at the earliest time he would have been eligible if the plan had been in existence and (2) that contributions have been made on this basis from the entry age to the date of the actuarial valuation. The contributions are the level annual amounts which, if accumulated at the rate of interest used in the actuarial valuation, would result in a fund equal to the present value of the pensions at retirement for the employees who survive to that time.

Normal cost under this method is the level amount to be contributed for each year. When a plan is established after the company has been in existence for some time, past service cost under this method at the plan's inception date is theoretically the amount of the fund that would have been accumulated had annual contributions equal to the normal cost been made in prior years.

In theory, the entry age normal method is applied on an individual basis. It may be applied, however, on an aggregate basis, in which case separate amounts are not determined for individual employees. Further variations in practice often encountered are (1) the use of an average entry age, (2) the use, particularly when benefits are based on employees' earnings, of a level percentage of payroll in determining annual payments and (3) the computation of past service cost as the difference between the present value of employees' projected benefits and the present value of the employer's projected normal cost contributions. In some plans, the normal cost contribution rate may be based on a stated amount per employee. In other plans the normal cost contribution itself may be stated as a flat amount.

In valuations for years other than the initial year the past service cost may be frozen (that is, the unfunded amount of such cost is changed only to recognize payments and the effect of interest). Accordingly, actuarial gains and losses are spread into the future, entering into the normal cost for future years. If past service cost is not frozen, the unfunded amount includes the effects of actuarial gains and losses realized prior to the date of the valuation being made.

The annual contribution under the entry age normal method ordinarily comprises (1) the normal cost and (2) an amount for past service cost. The latter may comprise only an amount equivalent to interest on the unfunded balance or may also include an amount intended to reduce the unfunded balance.

The entry age normal method is often used with trusteed plans and deposit administration contracts.

b. *Individual level premium method.* The individual level premium method assigns the cost of each employee's pension in level annual amounts, or as a level percentage of the employee's compensation, over the period from the inception date of a plan (or the date of his entry into the plan, if later) to his retirement date. Thus, past service cost is not determined separately but is included in normal cost.

The most common use of the individual level premium method is with funding by individual insurance or annuity policies. It may be used, however, with trusteed plans and deposit administration contracts.

In plans using individual annuity policies, the employer is protected against actuarial losses, since premiums paid are not ordinarily subject to retroactive increases. The insurance company may, however, pass part of any actuarial gains along to the employer by means of dividends. Employee turnover may be another source of actuarial gains under such insured plans, since all or part of the cash surrender values of policies previously purchased for employees leaving the employer for reasons other than retirement may revert to the company (or to the trust). Dividends and cash surrender values are ordinarily used to reduce the premiums payable for the next period.

The individual level premium method generates annual costs which are initially very high and which ultimately drop to the level of the normal cost determined under the entry age normal method. The high initial costs arise because the past service cost (although not separately identified) for employees near retirement when the plan is adopted is in effect amortized over a very short period.

c. *Aggregate method.* The aggregate method applies on a collective basis the principle followed for individuals in the individual level premium method. That is, the entire unfunded cost of future pension benefits (including benefits to be paid to employees who have retired as of the date of the valuation) is spread over the average future service lives of employees who are active as of the date of the valuation. In most cases this is done by the use of a percentage of payroll.

The aggregate method does not deal separately with past service cost (but includes such cost in normal cost). Actuarial gains and losses enter into the determination of the contribution rate and, consequently, are spread over future periods.

Annual contributions under the aggregate method decrease, but the rate of decrease is less extreme than under the individual level premium method. The aggregate cost method amortizes past service cost (not separately identified) over the average future service lives of employees, thus avoiding the very short individual amortization periods of the individual level premium method.

The aggregate method may be modified by introducing past service cost. If the past service cost is determined by the entry age normal method, the modified aggregate method is the same as the entry age normal method applied on the aggregate basis. If the past service cost is determined by the unit credit method, the modified aggregate method is called the attained age normal method (discussed below).

The aggregate method is used principally with trusteed plans and deposit administration contracts.

d. *Attained age normal method.* The attained age normal method is a variant of the aggregate method or individual level premium method in which past service cost, determined under the unit credit method, is recognized separately. The cost of each employee's benefits assigned to years after the inception of the plan is spread over the employee's future service life. Normal cost contributions under the attained age normal method, usually determined as a percentage of payroll, tend to decline but less markedly than under the aggregate method or the individual level premium method.

As with the unit credit and entry age normal methods, the annual contribution for past service cost may comprise only an amount equivalent to interest on the unfunded balance or may also include an amount intended to reduce the unfunded balance.

The attained age normal method is used with trusteed plans and deposit administration contracts.

Terminal funding

Under terminal funding, funding for future benefit payments is made only at the end of an employee's period of active service. At that time the employer either purchases a single-premium annuity which will provide the retirement benefit or makes an actuarially equivalent contribution to a trust. (Note—This method is not acceptable for determining the provision for pension cost under the accompanying Opinion.)

APPENDIX B—GLOSSARY

Accrue (Accrual). When *accrue (accrual)* is used in accounting discussions in the accompanying Opinion, it has the customary accounting meaning. When used in relation to actuarial terms or procedures, however, the intended meaning differs somewhat. When actuaries say that pension benefits, actuarial costs or actuarial liabilities have *accrued,* they ordinarily mean that the amounts are associated, either specifically or by a process of allocation, with years of employee service before the date of a particular valuation of a pension plan. Actuaries do not ordinarily intend their use of the word *accrue* to have the more conclusive accounting significance.

Accrued Benefit Cost Method. An *actuarial cost method.* See Appendix A.

Actuarial Assumptions. Factors which actuaries use in tentatively resolving uncertainties concerning future events affecting pension cost; for example, mortality rate, employee turnover, compensation levels, investment earnings, etc. See Appendix A.

Actuarial Cost Method. A particular technique used by actuaries for establishing the amount and incidence of the annual actuarial cost of pension plan benefits, or benefits and expenses, and the related actuarial liability. Sometimes called *funding method.* See Appendix A.

Actuarial Gains (Losses). The effects on actuarially calculated pension cost of (a) deviations between actual prior experience and the actuarial assumptions used or (b) changes in actuarial assumptions as to future events.

Actuarial Liability. The excess of the present value, as of the date of a pension plan valuation, of prospective pension benefits and administrative expenses over the sum of (1) the amount in the pension fund and (2) the present value of future contributions for normal cost determined by any of several actuarial cost methods. (Sometimes referred to as *unfunded actuarial liability.*)

Actuarial Valuation. The process by which an actuary estimates the present value of benefits to be paid under a pension plan and calculates the amounts of employer contributions or accounting charges for pension cost. See Appendix A.

Actuarially Computed Value. See *present value.*

Actuarially Computed Value of Vested Benefits. See *vested benefits.*

Actuary. There are no statutory qualifications required for actuaries. Membership in the American Academy of Actuaries, a comprehensive organization of the profession in the United States, is generally considered to be acceptable evidence of professional qualification.

Aggregate Method. An *actuarial cost method.* See Appendix A.

Assumptions. See *actuarial assumptions.*

Attained Age Normal Method. An *actuarial cost method.* See Appendix A.

Benefits (Pension Benefits) (Retirement Benefits). The pensions and any other payments to which employees or their beneficiaries may be entitled under a pension plan.

Contribute (Contribution). When used in connection with a pension plan, *contribute* ordinarily is synonymous with pay.

Deferred Compensation Plan. An arrangement whereby specified portions of the employee's compensation are payable in the form of retirement benefits.

Deferred Profit-Sharing Plan. An arrangement whereby an employer provides for future retirement benefits for employees from specified portions of the earnings of the business; the benefits for each employee are usually the amounts which can be provided by accumulated amounts specifically allocated to him.

Defined-Benefit Plan. A pension plan stating the benefits to be received by employees after retirement, or the method of determining such benefits. The employer's contributions under such a plan are determined actuarially on the basis of the benefits expected to become payable.

Defined-Contribution Plan. A pension plan which (a) states the benefits to be received by employees after retirement or the method of determining such benefits (as in the case of a defined-benefit plan) and (b) accompanies a separate agreement that provides a formula for calculating the employer's contributions (for example, a fixed amount for each ton produced or for each hour worked, or a fixed percentage of compensation). Initially, the benefits stated in the plan are those which the contributions expected to be made by the employer can provide. If later the contributions are found to be inadequate or excessive for the purpose of funding the stated benefits on the basis originally contemplated, either the contributions or the benefits, or both, may be subsequently adjusted. In one type of defined-contribution plan (money-purchase plan) the employer's contributions are determined for, and allocated with respect to, specific individuals, usually as a percentage of compensation; the benefits for each employee are the amounts which can be provided by the sums contributed for him.

Deposit Administration Contract. A funding instrument provided by an insurance company under which amounts contributed by an employer are not identified with specific employees until they retire. When an employee retires, the insurance company issues an annuity which will provide the benefits stipulated in the pension plan and transfers the single premium for the annuity from the employer's accumulated contributions.

Entry Age Normal Method. An *actuarial cost method.* See Appendix A.

Fund. Used as a verb, *fund* means to pay over to a funding agency. Used as a noun, *fund* refers to assets accumulated in the hands of a funding agency for the purpose of meeting retirement benefits when they become due.

Funded. The portion of pension cost that has been paid to a funding agency is said to have been *funded.*

Funding Agency. An organization or individual, such as a specific corporate or individual trustee or an insurance company, which provides facilities for the accumulation of assets to be used for the payment of benefits under a pension plan; an organization, such as a specific life insurance company, which provides facilities for the purchase of such benefits.

Funding Method. See *actuarial cost method.*

Individual Level Premium Method. An *actuarial cost method.* See Appendix A.

Interest. The return earned or to be earned on funds invested or to be invested to provide for future pension benefits. In calling the return *interest,* it is recognized that in addition to interest on debt securities the earnings of a pension fund may include dividends on equity securities, rentals on real estate, and realized and unrealized gains or (as offsets) losses on fund investments. See Appendix A.

Mortality Rate. Death rate—the proportion of the number of deaths in a specified group to the number living at the beginning of the period in which the deaths occur. Actuaries use mortality tables, which show death rates for each age, in estimating the amount of future retirement benefits which will become payable. See Appendix A.

Normal Cost. The annual cost assigned, under the actuarial cost method in use, to years subsequent to the inception of a pension plan or to a particular valuation date. See *past service cost, prior service cost.*

Past Service Cost. Pension cost assigned, under the actuarial cost method in use, to years prior to the inception of a pension plan. See *normal cost, prior service cost.*

Pay-As-You-Go. A method of recognizing pension cost only when benefits are paid to retired employees. (Note—This is not an acceptable method for accounting purposes under the accompanying Opinion.)

Pension Fund. See *fund.*

Present Value (Actuarially Computed Value). The current worth of an amount or series of amounts payable or receivable in the future. *Present value* is determined by discounting the future amount or amounts at a predetermined rate of interest. In pension plan valuations, actuaries often combine arithmetic factors representing probability (e.g., mortality, withdrawal, future compensation levels) with arithmetic factors representing discount (interest). Consequently, to actuaries, determining the present value of future pension benefits may mean applying factors of both types.

Prior Service Cost. Pension cost assigned, under the actuarial cost method in use, to years prior to the date of a particular actuarial valuation. *Prior service cost* includes any remaining past service cost. See *normal cost, past service cost.*

Projected Benefit Cost Method. A type of *actuarial cost method.* See Appendix A.

Provision (Provide). An accounting term meaning a charge against income for an estimated expense, such as pension cost.

Service. Employment taken into consideration under a pension plan. Years of employment before the inception of a plan constitute an employee's past service; years thereafter are classified in relation to the particular actuarial valuation being made or discussed. Years of employment (including past service) prior to the date of a particular valuation constitute prior service; years of employment following the date of the valuation constitute future service.

Terminal Funding. An *actuarial cost method.* See Appendix A. (Note—This is not an acceptable *actuarial cost method* for accounting purposes under the accompanying Opinion.)

Trust Fund Plan. A pension plan for which the funding instrument is a trust agreement.

Turnover. Termination of employment for a reason other than death or retirement. See *withdrawal,* Appendix A.

Unit Credit Method. An *actuarial cost method.* See Appendix A.

Valuation. See *actuarial valuation,* Appendix A.

Vested Benefits. Benefits that are not contingent on the employee's continuing in the service of the employer. In some plans the payment of the benefits will begin only when the employee reaches the normal retirement date; in other plans the payment of the benefits will begin when the employee retires (which may be before or after the normal retirement date). The *actuarially computed value of vested benefits,* as used in this Opinion, represents the present value, at the date of determination, of the sum of (a) the benefits expected to become payable to former employees who have retired, or who have terminated service with vested rights, at the date of determination; and (b) the benefits, based on service rendered prior to the date of determination, expected to become payable at future dates to present employees, taking into account the probable time that employees will retire, at the vesting percentages applicable at the date of determination. The determination of vested benefits is not affected by other conditions, such as inadequacy of the pension fund, which may prevent the employee from receiving the vested benefits.

Withdrawal. The removal of an employee from coverage under a pension plan for a reason other than death or retirement. See *turnover.*

Opinion No. 9

REPORTING THE RESULTS OF OPERATIONS

DECEMBER, 1966

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INTRODUCTION

1. The American Institute of Certified Public Accountants, through its boards and committees, reviews from time to time the form and content of financial statements to determine how their usefulness may be improved. This Opinion is the result of a review of present practice in the reporting of the results of operations of business entities.

2. This Opinion supersedes (a) Chapter 2B, *Combined Statement of Income and Earned Surplus* of Accounting Research Bulletin No. 43; (b) Chapter 8, *Income and Earned Surplus* of Accounting Research Bulletin No.

43; and (c) Accounting Research Bulletin No. 49, *Earnings per Share.* It also modifies Chapter 5, *Intangible Assets* (paragraphs 5, 6, 8 and 9); Chapter 10A, *Real and Personal Property Taxes* (paragraph 19); Chapter 10B, *Income Taxes* (paragraphs 15 and 17); Chapter 11B, *Government Contracts—Renegotiation* (paragraph 9); Chapter 12, *Foreign Operations and Foreign Exchange* (paragraph 21); and Chapter 15, *Unamortized Discount, Issue Cost, and Redemption Premium on Bonds Refunded* (paragraphs 7 and 17) of Accounting Research Bulletin No. 43 to the extent the paragraphs indicated specify a particular treatment within income or retained earnings.

3. This Opinion (a) concludes that net income should reflect all items of profit and loss recognized during the period except for prior period adjustments, with extraordinary items to be shown separately as an element of net income of the period, (b) specifies the criteria to be used in determining which items, if any, recognized during the current period are to be considered extraordinary items, (c) specifies the criteria to be used in determining which items, if any, recognized during the current period are to be considered prior period adjustments and excluded from net income for the current period and (d) specifies the statement format and terminology to be used and the disclosures to be made when extraordinary items or prior period adjustments are present.

4. This Opinion also specifies the method of treating extraordinary items and prior period adjustments in comparative statements for two or more periods, specifies the disclosures required when previously issued statements of income are restated and recommends methods of presentation of historical, statistical-type financial summaries which include extraordinary items or are affected by prior period adjustments. In Part II, this Opinion specifies how earnings per share and dividends per share should be computed and reported.

5. For convenience, the term *net income* is used herein to refer to either net income or net loss. Similarly, *net income per share* or *earnings per share* is used to refer to either net income (or earnings) per share or net loss per share.

Applicability

6. This Opinion applies to general purpose statements which purport to present results of operations in conformity with generally accepted accounting principles. Investment companies, insurance companies and certain nonprofit organizations have developed income statements with formats different from those of the typical commercial entity described herein, designed to highlight the peculiar nature and sources of their income or operating results. The portion of this Opinion which requires that net income be presented as one amount does not apply to such entities. A committee of the American Institute of Certified Public Accountants is in the process of recommending a format for the income statement of commercial banks. Until such recommendation has been given and until the Board has taken a position thereon, this Opinion is not applicable to commercial banks.

I—Net Income and the Treatment of Extraordinary Items and Prior Period Adjustments

DISCUSSION

General

7. Business entities have developed a reporting pattern under which periodic financial statements are prepared from their accounting records to reflect the financial position of the entity at a particular date and the financial results of its activities for a specified period or periods. The statement of income and the statement of retained earnings (separately or combined) are designed to reflect, in a broad sense, the "results of operations."

8. A problem in reporting the results of operations of a business entity for one or more periods is the treatment of extraordinary items and prior period adjustments. This Opinion discusses the nature of events and transactions which might be considered "extraordinary," establishes related criteria which the Board feels are reasonable and practicable, and specifies the method and extent of disclosure of such items in the financial statements. The Opinion also discusses the various types of adjustment which might be considered to be proper adjustments of the recorded results of operations of prior periods and establishes criteria which the Board feels are reasonable and practicable for the relatively few items which should be so recognized.

Historical Background

General

9. There is considerable diversity of views as to whether extraordinary items and prior period adjustments should enter into the determination of net income of the period in which they are recognized. When Accounting Research Bulletin No. 32 was issued in December 1947, as well as when it was reissued in June 1953 as Chapter 8 of Accounting Research Bulletin No. 43, two conflicting viewpoints had attracted considerable support. The paragraphs which follow summarize the discussion of these two viewpoints contained in Chapter 8.

Current Operating Performance

10. Under one viewpoint, designated *current operating performance,* the principal emphasis is upon the ordinary, normal, recurring operations of the entity during the current period. If extraordinary or prior period transactions have occurred, their inclusion might impair the significance of net income to such an extent that misleading inferences might be drawn from the amount so designated.

11. Advocates of this position believe that users of financial statements attach a particular business significance to the statement of income and the "net income" reported therein. They point out that, while some users are able to analyze a statement of income and to eliminate from it those prior period adjustments and extraordinary items which may tend to impair its usefulness for their purposes, many users are not trained to do this. They believe that management (subject to the attestation of the independent auditors) is in a better position to do this, and to eliminate the effect of such items from the amount designated as net income.

12. Advocates of this position also point out that many companies, in order to give more useful information concerning their earnings performance, restate the earnings or losses of affected periods to reflect the proper allocation of prior period adjustments. They believe therefore that items of this type may best be handled as direct adjustments of retained earnings or as "special items" excluded from net income of the current period. They feel that extraordinary items of *all* types may often best be disclosed as direct adjustments of retained earnings, since this eliminates any distortive effect on reported earnings.

All Inclusive

13. Under the other viewpoint, designated *all inclusive,* net income is presumed to include all transactions affecting the net increase or decrease in proprietorship equity during the current period, except dividend distributions and transactions of a capital nature.

14. Proponents of this position believe that the aggregate of such periodic net incomes, over the life of an enterprise, constitutes total net income, and that this is the only fair and complete method of reporting the results of operations of the entity. They believe that extraordinary items and prior period adjustments are part of the earnings history of an entity and that omission of such items from periodic statements of income increases the possibility that these items will be overlooked in a review of operating results for a period of years. They also stress the dangers of possible manipulation of annual earnings figures if such items may be omitted from the determination of net income. They believe that a statement of income including all such items is easy to understand and less subject to variations resulting from different judgments. They feel that, when judgment is allowed to determine whether to include or exclude particular items or adjustments, significant differences develop in the treatment of borderline cases and that there is a danger that the use of "extraordinary" as a criterion may be a means of equalizing income. Advocates of this theory believe that full disclosure in the income statement of the nature of any extraordinary items or prior period adjustments during each period will enable the user of a statement of income to make his own assessment of the importance of the items and their effects on operating results.

Decisions of Committee on Accounting Procedure—Subsequent Developments

15. The committee on accounting procedure (predecessor of the Accounting Principles Board) did not embrace either of these viewpoints in its entirety in issuing its first Accounting Research Bulletin on this subject in December 1947. Instead, the committee stated ". . . . it is the opinion of the committee that there should be a general presumption that all items of profit and loss recognized during the period are to be used in determining the figure reported as net income. The only possible exception to this presumption in any case would be with respect to items which in the aggregate are materially significant in relation to the company's net income and are clearly not identifiable with or do not result from the usual or typical business operations of the period. Thus, only extraordinary items such as the

following may be excluded from the determination of net income for the year, and they should be excluded when their inclusion would impair the significance of net income so that misleading inferences might be drawn therefrom: . . ."[1] The list of items which followed consisted of material charges or credits, other than ordinary adjustments of a recurring nature, (a) specifically related to operations of prior years, (b) resulting from unusual sales of assets not acquired for resale and not of the type in which the company usually deals, (c) resulting from losses of a type not usually insured against, (d) resulting from the write-off of a material amount of intangibles or a material amount of unamortized bond discount or premium and expense. The language quoted above was continued substantially unchanged in the 1953 *Restatement and Revision of Accounting Research Bulletins,* becoming Chapter 8 of ARB No. 43.

16. Since the issuance of these guidelines for the determination of net income, developments in the business and investment environment have increased the emphasis on, and interest in, the financial reporting format of business entities and the nature of the amount shown as net income therein. As a result of the widespread and increasing dissemination of financial data, often in highly condensed form, to investors and potential investors, suggestions have been made that the criteria for the determination of the amount to be reported as net income, insofar as it is affected by extraordinary items and prior period adjustments, should be re-examined.

OPINION

Summary

17. The Board has considered various methods of reporting the effects of extraordinary events and transactions and of prior period adjustments which are recorded in the accounts during a particular accounting period. The Board has concluded that net income should reflect all items of profit and loss recognized during the period with the sole exception of the prior period adjustments described below. *Extraordinary items* should, however, be segregated from the results of ordinary operations and shown separately in the income statement, with disclosure of the nature and amounts thereof. The criteria for determination of extraordinary items are described in paragraph 21 below.

18. With respect to *prior period adjustments,* the Board has concluded that those rare items which relate directly to the operations of a specific prior period or periods, which are material and which qualify under the criteria described in paragraphs 23 and 25 below should, in single period statements, be reflected as adjustments of the opening balance of retained earnings. When comparative statements are presented, corresponding adjustments should be made of the amounts of net income (and the components thereof) and retained earnings balances (as well as of other affected balances) for all of the periods reported therein, to reflect the retroactive application of the prior period adjustments. (See paragraph 26 for required disclosures of prior period adjustments.)

19. The Board has concluded that the above approach to the reporting of the results of operations of business entities will result in the most meaningful and useful type of financial presentation. The principal advantages are: (a) inclusion of all operating items related to the current period, with segregation and disclosure of the extraordinary items, (b) a reporting of current income from operations free from distortions resulting from material items directly related to prior periods and (c) proper retroactive reflection in comparative financial statements of material adjustments relating directly to prior periods. In reaching its conclusion, the Board recognizes that this approach may involve (a) occasional revision of previously-reported net income for prior periods to reflect subsequently recorded material items directly related thereto, (b) difficulty in segregating extraordinary items and items related to prior periods and (c) the possibility that disclosures regarding adjustments of opening balances in retained earnings or of net income of prior periods will be overlooked by the reader.

Income Statement Presentation

20. Under this approach, the income statement should disclose the following elements:

Income before extraordinary items

Extraordinary items
(less applicable income tax)

Net income

[1] Accounting Research Bulletin No. 32, *Income and Earned Surplus.*

If the extraordinary items are few in number, descriptive captions may replace the caption *extraordinary items* and related notes. In such cases, the first and last captions shown above should nonetheless appear. Similarly, even though material extraordinary items may net to an immaterial amount, they should be positioned and disclosed as indicated above, and the first and last captions shown above should appear. If there are no extraordinary items, the caption *net income* should replace the three captions shown above. The amount of income tax applicable to the segregated items should be disclosed, either on the face of the income statement or in a note thereto. (The amount of prior period adjustments and the amount of income tax applicable thereto should also be disclosed, as outlined in paragraph 26.) Illustrative examples of the treatment of such items in financial statements appear herein as Exhibits A through D.

Criteria for Extraordinary Items Related to the Current Period

21. The segregation in the income statement of the effects of events and transactions which have occurred during the current period, which are of an extraordinary nature and whose effects are material requires the exercise of judgment. (In determining materiality, items of a similar nature should be considered in the aggregate. Dissimilar items should be considered individually; however, if they are few in number, they should be considered in the aggregate.) Such events and transactions are identified primarily by the nature of the underlying occurrence. They will be of a character significantly different from the typical or customary business activities of the entity. Accordingly, they will be events and transactions of material effect which would not be expected to recur frequently and which would not be considered as recurring factors in any evaluation of the ordinary operating processes of the business. Examples of extraordinary items, assuming that each case qualifies under the criteria outlined above, include material gains or losses (or provisions for losses) from (a) the sale or abandonment of a plant or a significant segment of the business,[2] (b) the sale of an investment not acquired for resale, (c) the write-off of goodwill due to unusual events or developments within the period, (d) the condemnation or expropriation of properties and (e) a major devaluation of a foreign currency. As indicated above, such material items, less applicable income tax effect, should be segregated, but reflected in the determination of net income.

22. Certain gains or losses (or provisions for losses), regardless of size, do not constitute extraordinary items (or prior period adjustments) because they are of a character typical of the customary business activities of the entity. Examples include (a) write-downs of receivables, inventories and research and development costs, (b) adjustments of accrued contract prices and (c) gains or losses from fluctuations of foreign exchange. The effects of items of this nature should be reflected in the determination of income before extraordinary items. If such effects are material, disclosure is recommended.

Criteria for Prior Period Adjustments

23. Adjustments related to prior periods—and thus excluded in the determination of net income for the current period—are limited to those material adjustments which (a) can be specifically identified with and directly related to the business activities of particular prior periods, and (b) are not attributable to economic events occurring subsequent to the date of the financial statements for the prior period, and (c) depend primarily on determinations by persons other than management and (d) were not susceptible of reasonable estimation prior to such determination. Such adjustments are rare in modern financial accounting. They relate to events or transactions which occurred in a prior period, the accounting effects of which could not be determined with reasonable assurance at that time, usually because of some major uncertainty then existing. Evidence of such an uncertainty would be disclosure thereof in the financial statements of the applicable period, or of an intervening period in those cases in which the uncertainty became apparent during a subsequent period. Further, it would be expected that, in most cases, the opinion of the reporting independent auditor on such prior period would have contained a qualification because of the uncertainty. Examples are material, nonrecurring adjustments or settlements of income taxes, of renegotiation proceedings or of utility revenue under rate processes. Settlements of significant amounts resulting from litigation or similar claims may also constitute prior period adjustments.

[2] Operating results prior to the decision as to sale or abandonment should not be considered an element of the extraordinary gain or loss.

24. Treatment as prior period adjustments should not be applied to the normal, recurring corrections and adjustments which are the natural result of the use of estimates inherent in the accounting process. For example, changes in the estimated remaining lives of fixed assets affect the computed amounts of depreciation, but these changes should be considered prospective in nature and not prior period adjustments. Similarly, relatively immaterial adjustments of provisions for liabilities (including income taxes) made in prior periods should be considered recurring items to be reflected in operations of the current period. Some uncertainties, for example those relating to the realization of assets (collectibility of accounts receivable, ultimate recovery of deferred costs or realizability of inventories or other assets), would not qualify for prior period adjustment treatment, since economic events subsequent to the date of the financial statements must of necessity enter into the elimination of any previously-existing uncertainty. Therefore, the effects of such matters are considered to be elements in the determination of net income for the period in which the uncertainty is eliminated. Thus, the Board believes that prior period adjustments will be rare.

25. A change in the application of accounting principles may create a situation in which retroactive application is appropriate. In such situations, these changes should receive the same treatment as that for prior period adjustments. Examples are changes in the basis of preparing consolidated financial statements or in the basis of carrying investments in subsidiaries (e.g., from cost to the equity method).

Disclosure of Prior Period Adjustments and Restatements of Reported Net Income

26. When prior period adjustments are recorded, the resulting effects (both gross and net of applicable income tax) on the net income of prior periods should be disclosed in the annual report for the year in which the adjustments are made.[3] When financial statements for a single period only are presented, this disclosure should indicate the effects of such restatement on the balance of retained earnings at the beginning of the period and on the net income of the immediately preceding period. When financial statements for more than one period are presented, which is ordinarily the preferable procedure,[4] the disclosure should include the effects for each of the periods included in the statements. Such disclosures should include the amounts of income tax applicable to the prior period adjustments. Disclosure of restatements in annual reports issued subsequent to the first such post-revision disclosure would ordinarily not be required.

Historical Summaries of Financial Data

27. It has become customary for business entities to present historical, statistical-type summaries of financial data for a number of periods—commonly five or ten years. The Board recommends that the format for reporting extraordinary items described in paragraph 20 be used in such summaries. The Board further recommends that, whenever prior period adjustments have been recorded during any of the periods included therein, the reported amounts of net income (and the components thereof), as well as other affected items, be appropriately restated, with disclosure in the first summary published after the adjustments.

Capital Transactions

28. The Board reaffirms the conclusion of the former committee on accounting procedure that the following should be excluded from the determination of net income or the results of operations under all circumstances: (a) adjustments or charges or credits resulting from transactions in the company's own capital stock,[5] (b) transfers to and from accounts properly designated as appropriated retained earnings (such as general purpose contingency reserves or provisions for replacement costs of fixed assets) and (c) adjustments made pursuant to a quasi-reorganization.

Illustrative Statements

29. Examples of financial statements illustrating applications of the Board's conclusions appear as Exhibits to this Opinion. The illustrative income statements are prepared in "single-step" form. The "multi-step" form is also acceptable. Regardless of the form used, the income statement should disclose revenues (sales), and the elements mentioned in paragraph 20 above should be clearly disclosed in the order there indicated.

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[3] The Board recommends disclosure, in addition, in interim reports issued during that year subsequent to the date of recording the adjustments.

[4] See ARB No. 43, Chapter 2A, *Form of Statements—Comparative Financial Statements.*

[5] See paragraph 12 of APB Opinion No. 6, *Status of Accounting Research Bulletins.*

II—Computation and Reporting of Earnings per Share

Introduction

30. Statistical presentations of periodic "net income per share," "net loss per share" or "earnings per share" are commonly used in prospectuses, proxy material and annual reports to stockholders, and in the compilation of business earnings data for the press, statistical services and other publications.[6] When presented in conjunction with formal financial statements for a number of periods, such information can be useful, together with other data, in evaluating the past operating performance of a business entity and attempting to form an opinion as to its future potential.

OPINION

General

31. The Board believes that earnings per share data are most useful when furnished in conjunction with a statement of income. Accordingly, the Board strongly recommends that earnings per share be disclosed in the statement of income.

32. It is the Board's opinion that the reporting of per share data should disclose amounts for (a) income before extraordinary items, (b) extraordinary items, if any, (less applicable income tax) and (c) net income—the total of (a) and (b). (See paragraph 20—Part I.) The Board believes that not only will this reporting format increase the usefulness of the reports of results of operations of business entities, but that it will also help to eliminate the tendency of many users to place undue emphasis on one amount reported as earnings per share. Illustrative examples of various methods of disclosure of per share data are included in Exhibits A to E herein.

Computations for Single Periods

General

33. When used without qualification, *earnings per share* refers to the amount of earnings applicable to each share of common stock or other residual security outstanding.[7] When more than one class of common stock is outstanding, or when an outstanding security has participating dividend rights with the common stock, or when an outstanding security clearly derives a major portion of its value from its conversion rights or its common stock characteristics, such securities should be considered "residual securities" and not "senior securities" for purposes of computing earnings per share. Appropriate consideration should be given to any senior dividend rights or interest relating to such securities, and to any participation provisions. (See also paragraph 49.) In order to compute earnings per share properly, consideration should be given to shares outstanding which are senior to the common stock, and to changes in the common and senior shares during the period. Procedures for doing so are outlined below. The term *common,* when used in this and subsequent paragraphs, includes "residual securities" as defined above.

Treatment of Senior Shares Outstanding

34. The term *earnings per share* should not be used with respect to outstanding shares of senior securities (e.g., preferred stock) in view of their limited dividend rights. In such cases it is often informative to show the number of times or the extent to which the dividend requirements of senior securities have been earned ("earnings coverage"), but such information should not be designated as earnings per share.

35. The claims of senior shares on earnings should be deducted from net income (and also from income before extraordinary items, if an amount therefor appears in the statement) before computing per share amounts applicable to residual securities. Therefore, in arriving at earnings applicable to common stock, provision should be made for cumulative preferred dividends for the period, whether or not earned. (In the case of a net loss, the amount of the loss should be increased by any cumulative preferred dividends for the period.) When cumulative preferred dividends are in arrears, the per share and aggregate amounts thereof should be disclosed. When preferred dividends are cumulative only if earned, no adjustment of this type is required, except to the extent of income available therefor. When preferred dividends are in no way cumulative, only the amount of such dividends declared during the period should be

[6] See Paragraph 5.

[7] When, as occasionally occurs in business combinations, an agreement exists to issue additional shares at a future date without additional consideration and without other significant conditions precedent (such as the attainment of specified levels of earnings), such shares are normally reflected in the balance sheet. These shares should be considered as outstanding for purposes of computing per share earnings data.

deducted. In all cases, the effect that has been given to dividend rights of senior securities in arriving at the earnings per share of residual securities should be disclosed.

Changes in Common or Senior Shares During the Period

36. The computation of earnings per share should be based on the weighted average number of shares outstanding during the period. Minor increases and decreases in the number of common shares outstanding during the period may be disregarded; under these conditions, the computation may be based on the number of common shares outstanding at the end of the period. For purposes of determining the number of shares outstanding, reacquired shares (including treasury stock) should be excluded. Major increases or decreases should be taken into consideration as discussed below.

37. When common shares are issued to acquire a business in a transaction which is accounted for as a purchase, the computation should be based on a weighted average of the shares outstanding during the period. When a business combination is accounted for as a pooling of interests, the computation should be based on the aggregate of the weighted average outstanding shares of the constituent businesses (adjusted to equivalent shares of the surviving business) determined in accordance with the provisions herein. This difference in treatment reflects the fact that, in a purchase, the results of operations of the acquired business are included in the statement of income only from the date of acquisition; whereas, in a pooling of interests, the results of operations are combined for the entire period. In the case of reorganizations, the computations should be based on an analysis of the particular transaction according to the criteria contained herein.

38. When senior stock or debt is converted into common stock during a period, earnings per share should be based on a weighted average of the number of shares outstanding during the period. Use of a weighted average makes unnecessary any adjustments with respect to interest or other related factors. Dividends on preferred stock applicable to the period prior to conversion should be handled in accordance with paragraph 35 above. Supplementary pro forma computations of earnings per share, showing what the earnings would have been if the conversion had taken place at the beginning of the period, should be furnished if the effect of conversion is material, as outlined in paragraph 41 below.

39. When the number of shares outstanding increases as a result of a stock dividend or stock split,[8] or decreases as a result of a reverse split, without significant proceeds or disbursements, the computation should give retroactive recognition to an appropriate equivalent change in capital structure for the entire period. When a decrease in the number of shares outstanding results from acquisition of treasury stock or from a transaction other than a reverse split, the computation should be based on a weighted average of the number of shares outstanding during the period.

Changes in Common or Senior Shares After Close of Period

40. When changes in common stock due to stock splits or reverse splits take place after the close of the period but before completion and issuance of the financial report, the per share computations should be based on the new number of shares, on a pro forma basis, since the reader's primary interest is presumed to be related to the current capitalization. Similar considerations apply to stock dividends, although a relatively small stock dividend may be disregarded. When per share computations reflect changes in the number of shares after the close of the period, this fact should be disclosed. It is usually not satisfactory to show two amounts of earnings per share under these circumstances.

41. When senior stock or debt is converted into common stock after the close of the period but before completion and issuance of the financial report, supplementary pro forma computations of earnings per share, showing what the earnings would have been if the conversion had taken place at the beginning of the latest period, should be furnished if the effect is material. In making these computations, dividends paid on the senior securities converted should not be deducted from the historical net income for the period; interest and related expenses on the debt converted, less applicable income tax, should be added to the historical net income of the period. The bases of these supplementary computations should be disclosed.

42. Occasionally a sale of common stock for cash is scheduled to occur after the close of the period but before completion and issuance of the financial report. When a

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[8] See ARB No. 43, Chapter 7B, *Capital Accounts—Stock Dividends and Stock Split-ups.*

portion or all of the proceeds of the sale are to be used to retire preferred stock or debt, supplementary pro forma computations of earnings per share should be furnished to show what the earnings would have been for the latest period if the retirement had taken place at the beginning of that period, if the effect is material. The average number of shares outstanding to be used in the computation should include those whose proceeds are to be used to retire the preferred stock or debt. The basis of these supplementary computations should be disclosed.

Contingent Changes and Dilution [9]

43. Under certain circumstances, earnings per share may be subject to dilution in the future if existing contingencies permitting issuance of common shares eventuate. Such circumstances include contingent changes resulting from the existence of (a) outstanding senior stock or debt which is convertible into common shares, (b) outstanding stock options, warrants or similar agreements and (c) agreements for the issuance of common shares for little or no consideration upon the satisfaction of certain conditions (e.g., the attainment of specified levels of earnings following a business combination). If such potential dilution is material, supplementary pro forma computations of earnings per share should be furnished, showing what the earnings would be if the conversions or contingent issuances took place. The Board strongly recommends that such per share data be disclosed in the statement of income. The methods of computation should follow those outlined in the preceding paragraphs. When increased earnings levels are a condition of issuance, as in (c) above, such earnings should be given appropriate recognition in the computation of potential dilution. (See also paragraph 49.)

44. The fact that the relationship between current market and conversion prices makes conversion or other contingent issuance unlikely in the foreseeable future is not sufficient basis for omission of the disclosure of the pro forma earnings per share data described in paragraph 43. Disclosure of the current conditions would, nonetheless, normally be desirable.

Computations for Two or More Periods (Including Historical, Statistical-Type Summaries in Annual Reports to Stockholders)

45. The criteria governing the computations of earnings per share for two or more periods, while generally conforming with those outlined above for single periods, vary somewhat depending on the nature and purpose of the presentation in which they appear. Variations in the capitalization structure of the entity during the periods may have substantial effects on earnings per share, and comparisons of such data without adequate explanations may tend to be misleading. Furthermore, unless such earnings statistics are presented in conjunction with financial statements and with other historical information, the usefulness of per share data in evaluating the past operating performance of a business entity and attempting to form an opinion as to its future potential is limited.

46. Annual reports to stockholders are generally considered to be primarily historical in nature. Thus, although a trend has developed in recent years to include statistical-type summaries of financial data for a number of years, the main emphasis in the financial statements themselves has been on the results of the broad business activities of the entity during the current year as compared with those of the immediately preceding year. Accordingly, the computations of earnings per share in annual reports to stockholders, whether related to the formal financial statements in comparative form for two years or to the historical summaries covering a period of years, should usually be based on the capitalization structure existing during each period. The computation for each year should therefore follow the criteria outlined in paragraphs 33 through 44 above. The principal exception to this practice of avoiding retroactive recomputations for changes in the capitalization structure occurs when a pooling of interests has occurred. Since the earnings of the pooled entities are combined for all periods, the capital structure used to compute earnings per share for all periods should reflect appropriate recognition of the securities issued in the pooling transaction. Other exceptions to this treatment are the result of (a) stock splits or reverse splits, and (b) stock dividends, including those in recurring small percentages which in the aggregate become material during the periods involved. In these situations the methods outlined in paragraphs 39 and 40 above should be followed for all of the periods involved. When changes in the capitalization structure of the types described in paragraphs 41 and 42 above occur after the close of the last period, or when contin-

[9] Paragraphs 43 and 44 do not apply to securities which, because of their characteristics, are accorded the treatments described in paragraph 33 or in note 7 thereto.

gencies exist (see paragraphs 43 and 44), supplementary pro forma computations for the latest period, as a minimum, should be furnished.

47. In those cases in which net income of a prior period has been restated as a result of a prior period adjustment during the current period, any earnings per share data should be based on the restated amount of net income. The effect of the restatement, expressed in per share terms, should be disclosed.

48. The Board recommends that management be guided by the methods outlined in paragraphs 45, 46 and 47 herein for computing and reporting earnings per share in historical, statistical-type summaries contained in annual reports to stockholders.

Other

49. The Board recognizes that it is impracticable, in this Opinion, to discuss all the possible conditions and circumstances under which it may be necessary or desirable to compute earnings per share. However, when situations not expressly covered in this Opinion occur, they should be dealt with in accordance with the guidelines and criteria outlined herein. Such determinations require careful consideration of all the facts, and the exercise of judgment. The resulting earnings per share data should reflect a realistic evaluation of all the attendant circumstances. In all unusual cases, the basis of the computations should be disclosed.

Dividends per Share

50. Dividends constitute historical facts and usually are so reported. However, in certain cases, such as those affected by stock dividends or splits or reverse splits, the presentation of dividends per share should be made in terms of the current equivalent of the number of shares outstanding at the time of the dividend, so that dividends per share and earnings per share will be stated on a comparable basis. A disclosure problem exists in presenting data as to dividends per share following a pooling of interests. If the dividend policies of the constituent companies were different, a combination of dividends declared may be misleading, even though the per share data are expressed in shares of the continuing company. In such cases, it is usually preferable to disclose the dividends declared per share by the principal constituent and to disclose, in addition, either the amount per equivalent share or the total amount for each period for the other constituent, with appropriate explanations of the circumstances. When dividends per share are presented on other than an historical basis, the basis of presentation should be disclosed.

Illustrative Statements

51. Examples illustrating the inclusion of per share data in financial statements in accordance with the Board's recommendations are shown in Exhibits A, B, D and E.

EFFECTIVE DATE

52. This Opinion shall be effective for fiscal periods beginning after December 31, 1966. However, where feasible the Board recommends earlier compliance with this Opinion. The Board also strongly recommends that, in comparative statements in which one or more periods are subject to this Opinion, the provisions of the Opinion be applied to all periods appearing therein.

The Opinion entitled "Reporting the Results of Operations" was adopted unanimously by the twenty members of the Board, of whom five, Messrs. Biegler, Catlett, Frese, Halvorson and Walker, assented with qualification.

Mr. Biegler assents to the issuance of this Opinion because he believes that the usefulness of the income statement to the investor is enhanced when all items of profit and loss relating to the period are included in the determination of net income and the results of the ordinary, recurring operations of a business are reported separately from extraordinary items. He believes that the caption described in paragraph 20 as "Income before extraordinary items" can best meet the needs of investors for an index of the results of and trends in ordinary recurring operations when there is excluded therefrom those gains or losses which are extraordinary because of the combination of rarity in the circumstances giving rise thereto and the abnormal size thereof. Accordingly, he dissents from the conclusion stated in paragraph 22 that certain types of gains or losses, *regardless of size,* must be reflected in the determination of "income before extraordinary items." He believes that the quality of being extraordinary can be derived from rarity or extreme infrequency in size, as well as from the nature of a transaction or event.

Mr. Catlett does not agree that the criteria for prior period adjustments as set forth in paragraphs 23 and 24 of this Opinion are established on a proper basis. He considers that the nature of the adjustment and the factors which cause it are controlling, and that any material item which is in fact applicable to, and a correction of, a prior period should be accounted for as an adjustment of that period. He believes that there are cases in which prior period adjustments are appropriate with respect to questions involving realization of assets, such as receivables, inventories and property. He is of the opinion (1) that the Board is establishing arbitrary rules to discourage or prohibit prior period adjustments rather than determining appropriate principles to be followed in reviewing the nature of the items involved, and (2) that the inclusion in the current period's net income of a material item which is really applicable to a prior period results in the financial statements for two periods being in error.

Mr. Walker, joined by Mr. Frese, recognizes that the Opinion attempts to set up the criteria to restrict the number of items deemed to be prior period adjustments which are to be excluded from net income of the year and thrown back to prior years by restating opening balances of retained earnings. He nevertheless feels that such treatment will result in continuing controversy and will be confusing to users of financial statements. He believes that such treatment should not be mandatory, but rather should be left to the judgment of the managements who have the primary responsibility for proper presentation to stockholders. He therefore recommends that the so-called "all inclusive" statement of income — consistently followed—and with adequate disclosure of material special items (including extraordinary and prior period items) should be permissive.

Mr. Halvorson concurs in the qualified assent expressed by Mr. Walker in respect of the mandatory exclusion of prior period adjustments from the current statement of income, and extends his qualification to the mandatory determination of an arbitrary "income before extraordinary items" within the determination of net income.

NOTES

Opinions present the considered opinion of at least two-thirds of the members of the Accounting Principles Board, reached on a formal vote after examination of the subject matter.

Except as indicated in the succeeding paragraph, the authority of the Opinions rests upon their general acceptability. While it is recognized that general rules may be subject to exception, the burden of justifying departures from Board Opinions must be assumed by those who adopt other practices.

Action of Council of the Institute (Special Bulletin, Disclosure of Departures From Opinions of Accounting Principles Board, *October 1964) provides that:*

a. "Generally accepted accounting principles" are those principles which have substantial authoritative support.

b. Opinions of the Accounting Principles Board constitute "substantial authoritative support."

c. "Substantial authoritative support" can exist for accounting principles that differ from Opinions of the Accounting Principles Board.

The Council action also requires that departures from Board Opinions be disclosed in footnotes to the financial statements or in independent auditors' reports when the effect of the departure on the financial statements is material.

Unless otherwise stated, Opinions of the Board are not intended to be retroactive. They are not intended to be applicable to immaterial items.

EXHIBITS

Illustrative Statements

The following examples illustrate the treatment of extraordinary items and prior period adjustments in financial statements. The format of the statements is illustrative only, and does not necessarily reflect a preference by the Accounting Principles Board for the format or for the intermediate captions shown. See Part I— paragraph 20 as to certain final captions. The statements do not include customary disclosures, such as the amount of depreciation expense for the period, which are not considered pertinent to the subject matter of this Opinion.

The illustrative examples, in comparative form, are as follows:

	Exhibit
Statement of Income and Retained Earnings	A
Statement of Income...........	B
Statement of Retained Earnings..	C
Statement of Income—Five Years	D
Disclosures of per share data when senior securities are outstanding or material potential dilution exists	E

EXHIBIT A

STATEMENT OF INCOME AND RETAINED EARNINGS

Years Ended December 31, 1967 and December 31, 1966

	1967	1966 (Note 2)
Net sales	$84,580,000	$75,650,000
Other income	80,000	100,000
	84,660,000	75,750,000
Cost and expenses—		
Cost of goods sold	60,000,000	55,600,000
Selling, general and administrative expenses	5,000,000	4,600,000
Interest expense	100,000	100,000
Other deductions	80,000	90,000
Income tax	9,350,000	7,370,000
	74,530,000	67,760,000
Income before extraordinary items	10,130,000	7,990,000
Extraordinary items, net of applicable income tax of $1,880,000 in 1967 (Note 1)	(2,040,000)	(1,280,000)
Net Income	8,090,000	6,710,000
Retained earnings at beginning of year—		
As previously reported	28,840,000	25,110,000
Adjustments (Note 2)	(3,160,000)	(1,760,000)
As restated	25,680,000	23,350,000
	33,770,000	30,060,000
Cash dividends on common stock—$.75 per share	4,380,000	4,380,000
Retained earnings at end of year	$29,390,000	$25,680,000
Per share of common stock—		
Income before extraordinary items	$1.73	$1.37
Extraordinary items, net of tax	(.34)	(.22)
Net income	$1.39	$1.15

Note 1

During 1967 the Company sold one of its plants at a net loss of $2,040,000, after applicable income tax reduction of $1,880,000. During 1966 the Company sold an investment in marketable securities at a loss of $1,280,000, with no income tax effect.

Note 2

The balance of retained earnings at December 31, 1966 has been restated from amounts previously reported to reflect a retroactive charge of $3,160,000 for additional income taxes settled in 1967. Of this amount, $1,400,000 ($.24 per share) is applicable to 1966 and has been reflected as an increase in tax expense for that year, the balance (applicable to years prior to 1966) being charged to retained earnings at January 1, 1966.

EXHIBIT B

STATEMENT OF INCOME

Years Ended December 31, 1967 and December 31, 1966

	1967	1966 (Note 2)
Net sales	$84,580,000	$75,650,000
Other income	80,000	100,000
	84,660,000	75,750,000
Cost and expenses—		
Cost of goods sold	60,000,000	55,600,000
Selling, general and administrative expenses	5,000,000	4,600,000
Interest expense	100,000	100,000
Other deductions	80,000	90,000
Income tax + 1,880,000 9,350,000	9,350,000	7,370,000
	74,530,000	67,760,000
Income before extraordinary items (per share: 1967—$1.73; 1966—$1.37)	10,130,000	7,990,000
Extraordinary items, less applicable income tax in 1967 (Note 1) (per share: 1967—$(.34); 1966—$(.22))	(2,040,000)	(1,280,000)
Net income (per share: 1967—$1.39; 1966—$1.15)	$ 8,090,000	$ 6,710,000

Note 1

During 1967 the Company sold one of its plants at a net loss of $2,040,000, after applicable income tax reduction of $1,880,000. During 1966 the Company sold an investment in marketable securities at a loss of $1,280,000, with no income tax effect.

Note 2

The balance of retained earnings at December 31, 1966 has been restated from amounts previously reported to reflect a retroactive charge of $3,160,000 for additional income taxes settled in 1967. Of this amount, $1,400,000 ($.24 per share) is applicable to 1966 and has been reflected as an increase in tax expense for that year, the balance (applicable to years prior to 1966) being charged to retained earnings at January 1, 1966.

EXHIBIT C

STATEMENT OF RETAINED EARNINGS

Years Ended December 31, 1967 and December 31, 1966

	1967	1966
Retained earnings at beginning of year—		
As previously reported	$28,840,000	$25,110,000
Adjustments (Note 2)	(3,160,000)	(1,760,000)
As restated	25,680,000	23,350,000
Net income	8,090,000	6,710,000
	33,770,000	30,060,000
Cash dividends on common stock— $.75 per share	4,380,000	4,380,000
Retained earnings at end of year	$29,390,000	$25,680,000

(See accompanying notes appearing on statement of income, Exhibit B.)

EXHIBIT D

STATEMENT OF INCOME
For the Five Years Ended December 31, 1967

	1963	1964	1965	1966	1967
	(In thousands of dollars)				
Net sales	$67,100	$66,700	$69,300	$75,650	$84,580
Other income	80	80	60	100	80
	67,180	66,780	69,360	75,750	84,660
Costs and expenses:					
Cost of goods sold	48,000	47,600	49,740	55,600	60,000
Selling, general and administrative expenses	4,300	4,200	4,500	4,600	5,000
Interest expense	120	100	90	100	100
Other deductions	80	80	60	90	80
Income tax	7,340	7,400	7,490	7,370	9,350
	59,840	59,380	61,880	67,760	74,530
Income before extraordinary items	7,340	7,400	7,480	7,990	10,130
Extraordinary items, net of applicable income tax (Note A)	—	760	—	(1,280)	(2,040)
Net income (Note B)	$ 7,340	$ 8,160	$ 7,480	$ 6,710	$ 8,090
Per share of common stock:					
Income before extraordinary items	$1.26	$1.27	$1.28	$1.37	$1.73
Extraordinary items, net of income tax	—	$ .12	—	$(.22)	$(.34)
Net income	$1.26	$1.39	$1.28	$1.15	$1.39

NOTE A

The extraordinary items consist of the following: 1964—gain as a result of condemnation of idle land, less applicable income tax of $254,000; 1966—loss on sale of investment in marketable securities, with no income tax effect; 1967—loss on sale of plant, less applicable income tax reduction $1,880,000.

NOTE B

The amounts of net income for 1963, 1964 and 1966 have been restated from amounts previously reported to reflect additional income taxes for such years settled in 1967. These retroactive adjustments reduced net income for such years by $860,000 ($.15 per share), $900,000 ($.15 per share) and $1,400,000 ($.24 per share), respectively, as follows:

	1963	1964	1966
	(In thousands of dollars)		
Previously reported	$8,200	$9,060	$8,110
Adjustments	860	900	1,400
As adjusted	$7,340	$8,160	$6,710

EXHIBIT E

DISCLOSURES OF PER SHARE DATA WHEN SENIOR SECURITIES ARE OUTSTANDING OR MATERIAL POTENTIAL DILUTION EXISTS

Senior Securities Outstanding

When senior securities are outstanding, per share data are preferably shown in the format illustrated in Exhibit A, that is, in a table at the bottom of the income statement and not against the captions of the statement itself. The preferred method is illustrated below:

Per Share Earnings Applicable to Common Stock (Note X)

Earnings before extraordinary items	$1.23	$ .87
Extraordinary items, net of tax	(.34)	(.22)
Earnings applicable to common stock	$ .89	$ .65

Note X

Per share data are based on the average number of common shares outstanding during each year, after recognition of the dividend requirements ($2,920,000) on the 5% preferred stock.

Material Potential Dilution Exists— Convertible Preferred Stock

Under these conditions, the basic and supplementary per share data are preferably shown at the bottom of the income statement, as in Exhibit A, with an additional note, as follows:

Per Share Earnings Applicable to Common Stock (Note X)

Earnings before extraordinary items	$1.23	$ .87
Extraordinary items, net of tax	(.34)	(.22)
Earnings applicable to common stock	$ .89	$ .65

Pro Forma Per Share of Common Stock, Reflecting Conversion (Note Y)

Income before extraordinary items	$ .99	$ .78
Extraordinary items, net of tax	(.20)	(.12)
Net income	$ .79	$ .66

Note X

Per share data are based on the average number of common shares outstanding during each year, after recognition of the dividend requirements ($2,920,000) on the 5% preferred stock.

Note Y

The pro forma per share data are based on the assumption that the outstanding 5% preferred shares were converted into common shares at the conversion ratio in effect at December 31, 1967, reflecting the 4,380,000 shares issuable on conversion and eliminating the preferred dividend requirements.

Material Potential Dilution Exists— Convertible Debt, No Preferred Stock

Under these conditions, the basic and supplementary per share data are preferably shown at the bottom of the income statement, as in Exhibit A, with an additional note, as follows:

Per Share of Common Stock

Income before extraordinary items	$1.73	$1.37
Extraordinary items, net of tax	(.34)	(.22)
Net income	$1.39	$1.15

Pro Forma Per Share of Common Stock, Reflecting Conversion (Note M)

Income before extraordinary items	$1.53	$1.21
Extraordinary items, net of tax	(.31)	(.19)
Net income	$1.22	$1.02

Note M

The pro forma per share data are based on the assumption that the 5½% convertible debentures outstanding at December 31, 1967 were converted into common shares at the conversion rate in effect at that date, reflecting the 800,000 shares issuable on conversion and eliminating the related interest on the convertible debentures (less applicable income tax) of $50,000.

APB Opinion No. 10

OMNIBUS OPINION—1966

DECEMBER, 1966

Consolidated Financial Statements
Poolings of Interest—Restatement of Financial Statements
Tax Allocation Accounts—Discounting
Offsetting Securities Against Taxes Payable
Convertible Debt and Debt Issued with Stock Warrants
Liquidation Preference of Preferred Stock
Installment Method of Accounting

INTRODUCTION

1. This is the first of a series of Opinions which the Board expects to issue periodically containing:

(a) Amendments of prior Opinions of the Accounting Principles Board and Accounting Research Bulletins of its predecessor, the committee on accounting procedure, as appear necessary to clarify their meaning or to describe their applicability under changed conditions.

(b) Affirmation of accounting principles and methods which have become generally accepted through practice and which the Board believes to be sound, and when it desires to prevent the possible development of less desirable alternatives.

(c) Conclusions as to appropriate accounting principles and methods on subjects not dealt with in previous pronouncements and for which a separate Opinion is not believed to be warranted.

CONSOLIDATED FINANCIAL STATEMENTS

(Amendment to Accounting Research Bulletin No. 51)

2. Paragraph 1 of ARB No. 51 states that "There is a presumption that consolidated statements . . . are usually necessary for a fair presentation when one of the companies in the group directly or indirectly has a controlling financial interest in the other companies." The usefulness of consolidated financial statements has been amply demonstrated by the widespread acceptance of this form of financial reporting. A research study on the broader subject of accounting for intercorporate investments is now in process which will encompass the matters covered in ARB No. 51. Pending consideration of that study the Board has adopted the following amendments to ARB No. 51.

3. If, in consolidated financial statements, a domestic subsidiary is not consolidated,[1] the Board's opinion is that, unless circumstances are such as those referred to in paragraph 2 of ARB No. 51,[2] the investment in the subsidiary should be adjusted for the consolidated group's share of accumulated undistributed earnings and losses since acquisition.[3] This practice is sometimes referred to as the "equity" method. In report-

[1] This paragraph modifies paragraphs 19 and 20 of ARB 51 insofar as they relate to domestic subsidiaries. An accounting research study on the subject of foreign investments and operations is in process. The Board has deferred consideration of the treatment of foreign subsidiaries in consolidated financial statements until the study is published. In the meantime, the provisions of Chapter 12 of ARB 43 (as amended by paragraph 18 of APB Opinion No. 6 and by paragraphs 17, 21 and 22 of APB Opinion No. 9) continue in effect.

The Board has also deferred consideration of the treatment of jointly owned (50 per cent or less) companies pending completion of the study on accounting for intercorporate investments.

[2] "For example, a subsidiary should not be consolidated where control is likely to be temporary, or where it does not rest with the majority owners (as, for instance, where the subsidiary is in legal reorganization or in bankruptcy)."

[3] Cumulative undistributed earnings at the effective date of this Opinion should be reflected, with a corresponding adjustment of retained earnings, and reported as a prior period adjustment resulting from a retroactive change in the application of an accounting principle; where

ing periodic consolidated net income, the earnings or losses of the unconsolidated subsidiary (or group of subsidiaries) should generally be presented as a separate item.[4] The amount of such earnings or losses should give effect to amortization, if appropriate, of any difference between the cost of the investment and the equity in net assets at date of acquisition and to any elimination of inter-company gains or losses that would have been made had the subsidiary been consolidated. If desired, dividends received by members of the consolidated group from the unconsolidated subsidiary may be shown parenthetically or by footnote. (See also paragraph 21 of ARB 51, which relates to disclosure of assets and liabilities of unconsolidated subsidiaries.)

4. The Board is of the opinion that, in the preparation of consolidated financial statements for periods subsequent to the effective date of this Opinion, the accounts of all subsidiaries (regardless of when organized or acquired) whose principal business activity is leasing property or facilities to their parents or other affiliates should be consolidated. The Board believes that the "equity" method, referred to in paragraph 3, which directs its emphasis primarily to recognizing results of operations of the enterprise as a whole, is not adequate for fair presentation in the case of these subsidiaries because of the significance of their assets and liabilities to the consolidated financial position of the enterprise.[5]

Messrs. Catlett and Davidson do not agree with paragraph 4 of this Opinion. They believe that the Board should not use this piecemeal pronouncement on consolidation principles to attempt to overcome some of the basic deficiencies in Opinion No. 5. A subsidiary of the type referred to in paragraph 4 represents one of several possible approaches to financing by means of leases, and in many such cases the noncancellable leases from the parent company are the principal security for the funds borrowed by the subsidiary; such leases, in effect, are obligations to outside lenders. The consolidation of such a subsidiary would increase further the existing confusion and lack of comparability between companies in the financial reporting of lease obligations, because the consolidation might involve (1) leases entered into prior to the effective date of Opinion No. 5, and (2) leases in which there is not the creation of a significant equity for the lessee in the property. They consider that the better solution to this problem would be for Opinion No. 5 to be revised to provide that material amounts payable under noncancellable leases should be shown as obligations (discounted to present value) in the balance sheets of all lessee companies.

POOLINGS OF INTERESTS—RESTATEMENT OF FINANCIAL STATEMENTS

5. Paragraph 12 of ARB No. 48 is amended to read as follows:

> 12. When a combination is considered to be a pooling of interests,[6] statements of results of operations issued by the continuing business for the period in which the combination occurs should include the combined results of operations of the constituent interests for the entire period in which the combination was effected. Similarly, if the pooling is consummated at or shortly after the close of the period, and before financial state-

the results of operations of prior periods would be materially affected, they should be restated. See paragraphs 25 of APB Opinion No. 9.

[4] Extraordinary items and prior period adjustments may require treatment in accordance with APB Opinion No. 9 if, on a consolidated basis, such items would be material in relation to consolidated net income. Thus, consolidated income before extraordinary items and consolidated net income would be the same as if the unconsolidated subsidiary were fully consolidated.

[5] The Board is giving further consideration to the accounting treatment of lease transactions. In the meantime, it has deferred expressing an opinion on the inclusion in consolidated financial statements of companies organized in connection with leasing transactions in which the equity interest, usually nominal at the time of organization, is held by third parties, but in which the principal lessee, through options or by similar devices, possesses or has the power to obtain the economic benefits of ownership from the lease arrangements. (This deferment does not affect the applicability of paragraph 12 of APB Opinion No. 5.)

[6] Accounting Research Study No. 5 on *A Critical Study of Accounting for Business Combinations* has been published, and another research study on accounting for goodwill is in process. The Board plans to reconsider the entire subject of accounting for business combinations after the latter study is published.

ments of the continuing business are issued, the financial statements should, if practicable, give effect to the pooling for the entire period being reported; in this case, information should also be furnished as to revenues and earnings of the constituent businesses for all periods presented. Results of operations, balance sheets and other historical financial data of the continuing business for periods (including interim periods) prior to that in which the combination was effected, when presented for comparative purposes, should be restated on a combined basis. In order to show the effect of poolings upon their earnings trends, companies may wish to provide reconciliations of amounts of revenues and earnings previously reported with those currently presented. Combined financial statements of pooled businesses should be clearly described as such, and disclosure should be made that a business combination has been treated as a pooling.

TAX ALLOCATION ACCOUNTS—DISCOUNTING

6. Accounting Research Study No. 9, *Interperiod Allocation of Corporate Income Taxes,*[7] deals with the allocation of income taxes among accounting periods when revenues and expenses are reported for financial accounting purposes in different periods than they are for income tax purposes. The Board is presently giving attention to this general subject with a view to issuing an Opinion on it. One of the questions now being considered is whether certain long-term tax allocation accounts should be determined on a discounted basis as recommended in the Study. Pending further consideration of this subject and the broader aspects of discounting as it is related to financial accounting in general and until the Board reaches a conclusion on this subject, it is the Board's opinion that, except for applications existing on the exposure date of this Opinion (September 26, 1966) with respect to transactions consummated prior to that date, deferred taxes should not be accounted for on a discounted basis.

Messrs. Davidson and Weston do not agree with the conclusion of the Board that further use of the discounting (or present value) technique in measuring the current cost of deferred income taxes is not acceptable, pending further consideration of this subject by the Board. They point out that Accounting Research Study No. 9 concluded that this method is required whenever the interest factor is significant. They recognize that the Board is attempting to prevent the development of an alternative practice until it has had an opportunity to consider the subject matter thoroughly and form an opinion thereon. On the other hand, the Board has required use of the discounting technique in measuring the present value of obligations due in the future in (a) the capitalization of leases (Opinion No. 5 — paragraph 15) and (b) the accrual of pension costs (Opinion No. 8 — paragraphs 23 and 42). They find it difficult to reconcile these inconsistent positions of the Board on similar questions of measurement. Furthermore, they believe that the Board is creating an unwise precedent by outlawing potential developments in practice which may be preferable to those presently in use, with the sole justification that the Board is not yet properly prepared to evaluate the merits of the developing practice. This position would, in the opinion of Messrs. Davidson and Weston, be detrimental to the sound development of accounting principles and practices through experience, which, in their considered view, is an effective means by which accounting techniques can be improved.

OFFSETTING SECURITIES AGAINST TAXES PAYABLE

7. Chapter 3B, entitled *Working Capital—Application of United States Government Securities Against Liabilities for Federal Taxes on Income,* of Accounting Research Bulletin No. 43 is withdrawn in its entirety. The following Chapter 3B, entitled *Offsetting Securities Against Taxes Payable,* is substituted in its place:

[7] Accounting Research Studies are not statements of this Board or of the American Institute of Certified Public Accountants, but are published for the purpose of stimulating discussion on important accounting issues.

1. It is a general principle of accounting that the offsetting of assets and liabilities in the balance sheet is improper except where a right of setoff exists. Accordingly, the offset of cash or other assets against the tax liability or other amounts owing to governmental bodies is not acceptable except in the circumstances described in paragraph 3 below.
2. Most securities now issued by governments are not by their terms designed specifically for the payment of taxes and, accordingly, should not be deducted from taxes payable on the balance sheet.
3. The only exception to this general principle occurs when it is clear that a purchase of securities (acceptable for the payment of taxes) is in substance an advance payment of taxes that will be payable in the relatively near future, so that in the special circumstances the purchase is tantamount to the prepayment of taxes. This occurs at times, for example, as an accommodation to a local government and in some instances when governments issue securities that are specifically designated as being acceptable for the payment of taxes of those governments.

CONVERTIBLE DEBT AND DEBT ISSUED WITH STOCK WARRANTS

8. A portion of the proceeds received for bonds or other debt obligations which are convertible into stock, or which are issued with warrants to purchase stock, is ordinarily attributable to the conversion privilege or to the warrants, a factor that is usually reflected in the stated interest rate. In substance, the acquirer of the debt obligation receives a "call" on the stock. Accordingly, the portion of the proceeds attributable to the conversion feature or the warrants should be accounted for as paid-in capital (typically by a credit to capital surplus); however, as the liability under the debt obligation is not reduced by such attribution, the corresponding charge should be to debt discount. The discount so recognized (or the reduced premium if the proceeds exceed the face amount of the debt obligation) should thereafter be accounted for in accordance with Chapter 15 of ARB No. 43 as amended by paragraph 19 of APB Opinion No. 6 and by paragraph 17 of APB Opinion No. 9. Upon conversion, the related unamortized debt discount should be accounted for as a reduction of the consideration for the securities being issued.

9. The discount or reduced premium, in the case of convertible debt obligations, may ordinarily be measured as the difference between the price at which the debt was issued and the estimated price for which it would have been issued in the absence of the conversion feature. Warrants are frequently traded and their fair value can usually be determined by market prices at the time the debt is issued; accordingly, proceeds of the issue can be allocated in proportion to the relative market values of the debt obligations and warrants.

LIQUIDATION PREFERENCE OF PREFERRED STOCK

10. Companies at times issue preferred (or other senior) stock which has a preference in involuntary liquidation considerably in excess of the par or stated value of the shares. The relationship between this preference in liquidation and the par or stated value of the shares may be of major significance to the users of the financial statements of those companies and the Board believes it highly desirable that it be prominently disclosed. Accordingly, the Board recommends that, in these cases, the liquidation preference of the stock be disclosed in the equity section of the balance sheet in the aggregate, either parenthetically or "in short," rather than on a per share basis or by disclosure in notes.

11. In addition, the financial statements should disclose, either on the face of the balance sheet or in notes pertaining thereto:

a. the aggregate or per share amounts at which preferred shares may be called or are subject to redemption through sinking fund operations or otherwise;

b. as called for by paragraph 35 of APB Opinion No. 9, the aggregate and per share amounts of arrearages in cumulative preferred dividends.

INSTALLMENT METHOD OF ACCOUNTING

12. Chapter 1A of ARB No. 43, paragraph 1, states that "Profit is deemed to be realized when a sale in the ordinary course of business is effected, unless the circumstances are such that the collection of the sale price is not reasonably assured." The Board reaffirms this statement; it believes that revenues should ordinarily be accounted for at the time a transaction is completed, with appropriate provision for uncollectible accounts. Accordingly, it concludes that, in the absence of the circumstances[8] referred to above, the installment method of recognizing revenue is not acceptable.

EFFECTIVE DATE OF THIS OPINION

13. This Opinion shall be effective for fiscal periods beginning after December 31, 1966 and does not have retroactive effect except as indicated in paragraphs 3, 4, 5 and 6. However, earlier application is encouraged.

The Opinion entitled "Omnibus Opinion—1966" was adopted unanimously by the twenty members of the Board, of whom two, Messrs. Catlett and Davidson, assented with qualification as to paragraph 4 and two, Messrs. Davidson and Weston, assented with qualification as to paragraph 6.

NOTES

Opinions present the considered opinion of at least two-thirds of the members of the Accounting Principles Board, reached on a formal vote after examination of the subject matter.

Except as indicated in the succeeding paragraph, the authority of the Opinions rests upon their general acceptability. While it is recognized that general rules may be subject to exception, the burden of justifying departures from Board Opinions must be assumed by those who adopt other practices.

Action of Council of the Institute (Special Bulletin, Disclosure of Departures from Opinions of Accounting Principles Board, *October, 1964) provides that:*

(a) "Generally accepted accounting principles" are those principles which have substantial authoritative support.

(b) Opinions of the Accounting Principles Board constitute "substantial authoritative support."

(c) "Substantial authoritative support" can exist for accounting principles that differ from Opinions of the Accounting Principles Board.

The Council action also requires that departures from Board Opinions be disclosed in footnotes to the financial statements or in independent auditors' reports when the effect of the departure on the financial statements is material.

Unless otherwise stated, Opinions of the Board are not intended to be retroactive. They are not intended to be applicable to immaterial items.

Accounting Principles Board (1966-1967)

Clifford V. Heimbucher
Chairman
Marshall S. Armstrong
Donald J. Bevis
John C. Biegler
George R. Catlett
W. A. Crichley
Joseph P. Cummings
Sidney Davidson
Philip L. Defliese
Walter F. Frese
Newman T. Halvorson
LeRoy Layton
Oral L. Luper
John K. McClare
Robert J. Murphey
Louis H. Penney
John W. Queenan
Wilbert A. Walker
Frank T. Weston
Robert E. Witschey

[8] The Board recognizes that there are exceptional cases where receivables are collectible over an extended period of time and, because of the terms of the transactions or other conditions, there is no reasonable basis for estimating the degree of collectibility. When such circumstances exist, and as long as they exist, either the installment method or the cost recovery method of accounting may be used. (Under the cost recovery method, equal amounts of revenue and expense are recognized as collections are made until all costs have been recovered, postponing any recognition of profit until that time.)

APB Opinion No. 11

ACCOUNTING FOR INCOME TAXES

DECEMBER, 1967

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INTRODUCTION

1. This Opinion sets forth the Board's conclusions on some aspects of accounting for income taxes. These conclusions include significant modifications of views previously expressed by the Committee on Accounting Procedure and by the Board. Accordingly, this Opinion supersedes the following Accounting Research Bulletins (ARBs) and Opinions of the Accounting Principles Board (APBs):

a. ARB No. 43, Chapter 10, Section B, *Taxes: Income Taxes.*

b. Letter of April 15, 1959, addressed to the members of the Institute by the Committee on Accounting Procedure interpreting ARB 44 (Revised).

c. APB Opinion No. 6, *Status of Accounting Research Bulletins* (paragraphs 21 and 23).

2. This Opinion also amends the following ARBs and APBs insofar as they relate to accounting for income taxes:

a. ARB No. 43, Chapter 9, Section C, *Depreciation: Emergency Facilities—Depreciation, Amortization and Income Taxes* (paragraphs 11-13).

b. ARB No. 43, Chapter 11, Section B, *Government Contracts: Renegotiation* (paragraph 8).

c. ARB No. 43, Chapter 15, *Unamortized Discount, Issue Cost, and Redemption Premium on Bonds Refunded* (paragraph 11).

d. ARB No. 44 (Revised), *Declining-balance Depreciation* (paragraphs 4, 5, 7 and 10).

e. ARB No. 51, *Consolidated Financial Statements* (paragraph 17).

f. APB Opinion No. 1, *New Depreciation Guidelines and Rules* (paragraphs 1, 5, and 6).

g. APB Opinion No. 5, *Reporting of Leases in Financial Statements of Lessee* (paragraph 21).

3. *Discounting.* The Board's Opinion on "Tax Allocation Accounts—Discounting," as expressed in APB Opinion No. 10, *Omnibus Opinion—1966* (paragraph 6), continues in effect pending further study of the broader aspects of discounting as it is related to financial accounting in general.

4. *Investment Credits.* The Board is continuing its study on accounting for "Investment Credits" and intends to issue a new Opinion on the subject as soon as possible. In the meantime APB Opinion No. 2, *Accounting for the "Investment Credit,"* and APB Opinion No. 4 (Amending No. 2), *Accounting for the "Investment Credit,"* remain in effect.

5. Certain aspects of tax allocation, including illustrations of procedures and an extended discussion of alternative approaches to allocation, are presented in Accounting Research Study No. 9, *Interperiod Allocation of Corporate Income Taxes,* by Homer A. Black, published by the American Institute of Certified Public Accountants in 1966.[1] The Board has considered the Study and the comments received on it. The conclusions in this Opinion vary in some important respects from those reached in the Study.

APPLICABILITY

6. This Opinion applies to financial statements which purport to present financial position and results of operations in conformity with generally accepted accounting principles. It does not apply (a) to regulated industries in those circumstances where the standards described in the Addendum (which remains in effect) to APB Opinion No. 2 are met and (b) to special areas requiring further study as specifically indicated in paragraphs 38-41 of this Opinion. The Board has deferred consideration of the special problems of allocation of income taxes in interim financial statements and among components of a business enterprise pending further study and the issuance of Opinions on the applicability of generally accepted accounting principles to these statements.

7. The Board emphasizes that this Opinion, as in the case of all other Opinions, is not intended to apply to immaterial items.

[1] Accounting Research Studies are not statements of this Board, or of the Institute, but are published for the purpose of stimulating discussion on important accounting issues.

SUMMARY OF PROBLEMS

8. The principal problems in accounting for income taxes arise from the fact that some transactions[2] affect the determination of net income for financial accounting purposes in one reporting period and the computation of taxable income and income taxes payable in a different reporting period. The amount of income taxes determined to be payable for a period does not, therefore, necessarily represent the appropriate income tax expense applicable to transactions recognized for financial accounting purposes in that period. A major problem is, therefore, the measurement of the tax effects of such transactions and the extent to which the tax effects should be included in income tax expense in the same periods in which the transactions affect pretax accounting income.

9. The United States Internal Revenue Code permits a "net operating loss" of one period to be deducted in determining taxable income of other periods. This leads to the question of whether the tax effects of an operating loss should be recognized for financial accounting purposes in the period of loss or in the periods of reduction of taxable income.

10. Certain items includable in taxable income receive special treatment for financial accounting purposes, even though the items are reported in the same period in which they are reported for tax purposes. A question exists, therefore, as to whether the tax effects attributable to extraordinary items, adjustments of prior periods (or of the opening balance of retained earnings), and direct entries to other stockholders' equity accounts should be associated with the particular items for financial reporting purposes.[3]

11. Guidelines are needed for balance sheet and income statement presentation of the tax effects of timing differences, operating losses and similar items.

SUMMARY OF CONCLUSIONS

12. The Board's conclusions on some of the problems in accounting for income taxes are summarized as follows:

a. Interperiod tax allocation is an integral part of the determination of income tax expense, and income tax expense should include the tax effects of revenue and expense transactions included in the determination of pretax accounting income.

b. Interperiod tax allocation procedures should follow the deferred method,[4] both in the manner in which tax effects are initially recognized and in the manner in which deferred taxes are amortized in future periods.

c. The tax effects of operating loss carry*backs* should be allocated to the loss periods. The tax effects of operating loss carry*forwards*[5] usually should not be recognized until the periods of realization.

d. Tax allocation within a period should be applied to obtain fair presentation of the various components of results of operations.

e. Financial statement presentations of income tax expense and related deferred taxes should disclose (1) the composition of income tax expense as between amounts currently payable and amounts representing tax effects allocable to the period and (2) the classification of deferred taxes into a net current amount and a net noncurrent amount.

DEFINITIONS AND CONCEPTS

13. Terminology relating to the accounting for income taxes is varied; some terms have been used with different meanings. Definitions of certain terms used in this Opinion are therefore necessary.

a. *Income taxes.* Taxes based on income determined under provisions of the United States Internal Revenue Code and foreign, state and other taxes (including franchise taxes) based on income.

b. *Income tax expense.* The amount of income taxes (whether or not currently payable or refundable) allocable

[2] The term *transactions* refers to all transactions and other events requiring accounting recognition. As used in this Opinion, it relates either to individual events or to groups of similar events.

[3] See APB Opinion No. 9, *Reporting the Results of Operations.*

[4] See paragraph 19.

[5] The term "loss carry*forwards*" is used in this Opinion to mean "loss carryovers" as referred to in the United States Internal Revenue Code.

to a period in the determination of net income.

c. *Pretax accounting income.* Income or loss for a period, exclusive of related income tax expense.

d. *Taxable income.* The excess of revenues over deductions or the excess of deductions over revenues to be reported for income tax purposes for a period.[6]

e. *Timing differences.* Differences between the periods in which transactions affect taxable income and the periods in which they enter into the determination of pretax accounting income. Timing differences originate in one period and reverse or "turn around" in one or more subsequent periods. Some timing differences reduce income taxes that would otherwise be payable currently; others increase income taxes that would otherwise be payable currently.

f. *Permanent differences.* Differences between taxable income and pretax accounting income arising from transactions that, under applicable tax laws and regulations, will not be offset by corresponding differences or "turn around" in other periods.[7]

g. *Tax effects.* Differentials in income taxes of a period attributable to (1) revenue or expense transactions which enter into the determination of pretax accounting income in one period and into the determination of taxable income in another period, (2) deductions or credits that may be carried backward or forward for income tax purposes and (3) adjustments of prior periods (or of the opening balance of retained earnings) and direct entries to other stockholders' equity accounts which enter into the determination of taxable income in a period but which do not enter into the determination of pretax accounting income of that period. A permanent difference does not result in a "tax effect" as that term is used in this Opinion.

h. *Deferred taxes.* Tax effects which are deferred for allocation to income tax expense of future periods.

i. *Interperiod tax allocation.* The process of apportioning income taxes among periods.

j. *Tax allocation within a period.* The process of apportioning income tax expense applicable to a given period between income before extraordinary items and extraordinary items, and of associating the income tax effects of adjustments of prior periods (or of the opening balance of retained earnings) and direct entries to other stockholders' equity accounts with these items.

14. Certain general concepts and assumptions are recognized by the Board to be relevant in considering the problems of accounting for income taxes.

a. The operations of an entity subject to income taxes are expected to continue on a going concern basis, in the absence of evidence to the contrary, and income taxes are expected to continue to be assessed in the future.

b. Income taxes are an expense of business enterprises earning income subject to tax.

c. Accounting for income tax expense requires measurement and identification with the appropriate time period and therefore involves accrual, deferral and estimation concepts in the same manner as these concepts are applied in the measurement and time period identification of other expenses.

d. Matching is one of the basic processes of income determination; essentially it is a process of determining relationships between costs (including reductions of costs) and (1) specific revenues or (2) specific accounting periods. Expenses of the current period consist of those costs which are identified with the revenues of the current period and those costs which are identified with the current period on some basis other than revenue. Costs identifiable with future revenues or otherwise identifiable with future periods should be deferred to those future periods. When a cost cannot be related to future revenues or to future periods on some basis other than revenues, or it cannot reasonably be expected to be recovered from future revenues, it becomes, by necessity, an expense of the current period (or of a prior period).

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[6] For the purposes of this definition "deductions" do not include reductions in taxable income arising from net operating loss carrybacks or carryforwards.

[7] See paragraph 33.

TIMING DIFFERENCES

Discussion

Nature of Timing Differences

15. Four types of transactions are identifiable which give rise to timing differences; that is, differences between the periods in which the transactions affect taxable income and the periods in which they enter into the determination of pretax accounting income.[8] Each timing difference originates in one period and reverses in one or more subsequent periods.

a. Revenues or gains are included in taxable income later than they are included in pretax accounting income. For example, gross profits on installment sales are recognized for accounting purposes in the period of sale but are reported for tax purposes in the period the installments are collected.

b. Expenses or losses are deducted in determining taxable income later than they are deducted in determining pretax accounting income. For example, estimated costs of guarantees and of product warranty contracts are recognized for accounting purposes in the current period but are reported for tax purposes in the period paid or in which the liability becomes fixed.

c. Revenues or gains are included in taxable income earlier than they are included in pretax accounting income. For example, rents collected in advance are reported for tax purposes in the period in which they are received but are deferred for accounting purposes until later periods when they are earned.

d. Expenses or losses are deducted in determining taxable income earlier than they are deducted in determining pretax accounting income. For example, depreciation is reported on an accelerated basis for tax purposes but is reported on a straight-line basis for accounting purposes.

Additional examples of each type of timing difference are presented in Appendix A to this Opinion.

16. The timing differences of revenue and expense transactions entering into the determination of pretax accounting income create problems in the measurement of income tax expense for a period, since the income taxes payable for a period are not always determined by the same revenue and expense transactions used to determine pretax accounting income for the period. The amount of income taxes determined to be payable for a period does not, therefore, necessarily represent the appropriate income tax expense applicable to transactions recognized for financial accounting purposes in that period.

17. Interperiod tax allocation procedures have been developed to account for the tax effects of transactions which involve timing differences. Interperiod allocation of income taxes results in the recognition of tax effects in the same periods in which the related transactions are recognized in the determination of pretax accounting income.

Differing Viewpoints

18. Interpretations of the nature of timing differences are diverse, with the result that three basic methods of interperiod allocation of income taxes have developed and been adopted in practice. The three concepts and their applications are described and evaluated in Chapters 2, 3 and 4 of *Accounting Research Study No. 9.* A brief description of each method follows.

19. Interperiod tax allocation under the *deferred method* is a procedure whereby the tax effects of current timing differences are deferred currently and allocated to income tax expense of future periods when the timing differences reverse. The deferred method emphasizes the tax effects of timing differences on income of the period in which the differences originate. The deferred taxes are determined on the basis of the tax rates in effect at the time the timing differences originate and are not adjusted for subsequent changes in tax rates or to reflect the imposition of new taxes. The tax effects of transactions which reduce taxes currently payable are treated as deferred credits; the tax effects of transactions which increase taxes currently payable are treated as deferred charges. Amortization of these deferred taxes to income tax expense in future periods is based upon the nature of the transactions producing the tax effects and upon the manner in which these transactions enter into the determination of pretax accounting income in relation to taxable income.

20. Interperiod tax allocation under the *liability method* is a procedure whereby the income taxes expected to be paid on pretax

[8] Accounting Research Study No. 9, *Interperiod Allocation of Corporate Income Taxes*, pages 2-3 and 8-10.

accounting income are accrued currently. The taxes on components of pretax accounting income may be computed at different rates, depending upon the period in which the components were, or are expected to be, included in taxable income. The difference between income tax expense and income taxes payable in the periods in which the timing differences originate are either liabilities for taxes payable in the future or assets for prepaid taxes. The estimated amounts of future tax liabilities and prepaid taxes are computed at the tax rates expected to be in effect in the periods in which the timing differences reverse. Under the liability method the initial computations are considered to be tentative and are subject to future adjustment if tax rates change or new taxes are imposed.

21. Interperiod tax allocation under the *net of tax method* is a procedure whereby the tax effects (determined by either the deferred or liability methods) of timing differences are recognized in the valuation of assets and liabilities and the related revenues and expenses. The tax effects are applied to reduce specific assets or liabilities on the basis that tax deductibility or taxability are factors in their valuation.

22. In addition to the different methods of applying interperiod tax allocation, differing views exist as to the extent to which interperiod tax allocation should be applied in practice.

23. Some transactions result in differences between pretax accounting income and taxable income which are permanent[*] because under applicable tax laws and regulations the current differences will not be offset by corresponding differences in later periods. Other transactions, however, result in differences between pretax accounting income and taxable income which reverse or turn around in later periods; these differences are classified broadly as timing differences. The tax effects of certain timing differences often are offset in the reversal or turnaround period by the tax effects of similar differences originating in that period. Some view these differences as essentially the same as permanent differences because, in effect, the periods of reversal are indefinitely postponed. Others believe that differences which originate in a period and differences which reverse in the same period are distinguishable phases of separate timing differences and should be considered separately.

24. In determining the accounting recognition of the tax effects of timing differences, the first question is whether there should be any tax allocation. One view holds that interperiod tax allocation is never appropriate. Under this concept, income tax expense of a period equals income taxes payable for that period. This concept is based on the presumption that income tax expense of a period should be measured by the amount determined to be payable for that period by applying the laws and regulations of the governmental unit, and that the amount requires no adjustment or allocation. This concept has not been used widely in practice and is not supported presently to any significant extent.

25. The predominant view holds that interperiod tax allocation is appropriate. However, two alternative concepts exist as to the extent to which it should be applied: partial allocation and comprehensive allocation.

Partial Allocation

26. Under partial allocation the general presumption is that income tax expense of a period for financial accounting purposes should be the tax payable for the period. Holders of this view believe that when recurring differences between taxable income and pretax accounting income give rise to an indefinite postponement of an amount of tax payments or to continuing tax reductions, tax allocation is not required for these differences. They believe that amounts not reasonably expected to be payable to, or recoverable from, a government as taxes should not affect net income. They point out in particular that the application of tax allocation procedures to tax payments or recoveries which are postponed indefinitely involves contingencies which are at best remote and thus, in their opinion, may result in an overstatement or understatement of expenses with consequent effects on net income. An example of a recurring difference not requiring tax allocation under this view is the difference that arises when a company having a relatively stable or growing investment in depreciable assets uses straight-line depreciation in determining pretax accounting income but an accelerated method in determining taxable income. If tax allocation is applied by a company with large capital investments coupled with growth in depreciable assets (accentuated in periods of inflation) the resulting understatement of net income from using tax allocation is magnified.

27. Holders of the view expressed in paragraph 26 believe that the only excep-

[*] See Paragraph 33.

tions to the general presumption stated therein should be those instances in which specific nonrecurring differences between taxable income and pretax accounting income would lead to a material misstatement of income tax expense and net income. If such nonrecurring differences occur, income tax expense of a period for financial accounting purposes should be increased (or decreased) by income tax on differences between taxable income and pretax accounting income provided the amount of the increase (or decrease) can be reasonably expected to be paid as income tax (or recovered as a reduction of income taxes) within a relatively short period not exceeding, say, five years. An example would be an isolated installment sale of a productive facility in which the gross profit is reported for financial accounting purposes at the date of sale and for tax purposes when later collected. Thus, tax allocation is applicable only when the amounts are reasonably certain to affect the flow of resources used to pay taxes in the near future.

28. Holders of this view state that comprehensive tax allocation, as opposed to partial allocation, relies on the so-called "revolving" account approach which seems to suggest that there is a similarity between deferred tax accruals and other balance sheet items, like accounts payable, where the individual items within an account turn over regularly although the account balance remains constant or grows. For these other items, the turnover reflects actual, specific transactions—goods are received, liabilities are recorded and payments are subsequently made. For deferred tax accruals on the other hand, no such transactions occur—the amounts are not owed to anyone; there is no specific date on which they become payable, if ever; and the amounts are at best vague estimates depending on future tax rates and many other uncertain factors. Those who favor partial allocation suggest that accounting deals with actual events, and that those who would depart from the fact of the tax payment should show that the modification will increase the usefulness of the reports to management, investors or other users. To do this requires a demonstration that the current lower (or higher) tax payments will result in higher (or lower) cash outflows for taxes within a span of time that is of significant interest to readers of the financial statements.

Comprehensive Allocation

29. Under comprehensive allocation, income tax expense for a period includes the tax effects of transactions entering into the determination of pretax accounting income for the period even though some transactions may affect the determination of taxes payable in a different period. This view recognizes that the amount of income taxes payable for a given period does not necessarily measure the appropriate income tax expense related to transactions for that period. Under this view, income tax expense encompasses any accrual, deferral or estimation necessary to adjust the amount of income taxes payable for the period to measure the tax effects of those transactions included in pretax accounting income for that period. Those supporting comprehensive allocation believe that the tax effects of initial timing differences should be recognized and that the tax effects should be matched with or allocated to those periods in which the initial differences reverse. The fact that when the initial differences reverse other initial differences may offset any effect on the amount of taxable income does not, in their opinion, nullify the fact of the reversal. The offsetting relationships do not mean that the tax effects of the differences cannot be recognized and measured. Those supporting comprehensive allocation state that the makeup of the balances of certain deferred tax amounts "revolve" as the related differences reverse and are replaced by similar differences. These initial differences do reverse, and the tax effects thereof can be identified as readily as can those of other timing differences. While new differences may have an offsetting effect, this does not alter the fact of the reversal; without the reversal there would be different tax consequences. Accounting principles cannot be predicated on reliance that offsets will continue. Those supporting comprehensive allocation conclude that the fact that the tax effects of two transactions happen to go in opposite directions does not invalidate the necessity of recognizing separately the tax effects of the transactions as they occur.

30. Under comprehensive allocation, material tax effects are given recognition in the determination of income tax expense, and the tax effects are related to the periods in which the transactions enter into the determination of pretax accounting income. The tax effects so determined are allocated to the future periods in which the differences between pretax accounting income and taxable income reverse. Those supporting this view believe that comprehensive allocation is necessary in order to associate the tax effects with the related transactions. Only by the timely recognition of such tax effects

is it possible to associate the tax effects of transactions with those transactions as they enter into the determination of net income. The need exists to recognize the tax effects of initial differences because only by doing so will the income tax expense in the periods of initial differences include the tax effects of transactions of those periods.

31. Those who support comprehensive allocation believe that the partial allocation concept in stressing cash outlays represents a departure from the accrual basis of accounting. Comprehensive allocation, in their view, results in a more thorough and consistent association in the matching of revenues and expenses, one of the basic processes of income determination.

32. These differences in viewpoint become most significant with respect to the tax effects of transactions of a recurring nature—for example, depreciation of machinery and equipment using the straight-line method for financial accounting purposes and an accelerated method for income tax purposes. Under partial allocation the tax effects of these timing differences would not be recognized under many circumstances; under comprehensive allocation the tax effects would be recognized beginning in the periods of the initial timing differences. Under partial allocation, the tax effects of these timing differences would not be recognized so long as it is assumed that similar timing differences would arise in the future creating tax effects at least equal to the reversing tax effects of the previous timing differences. Thus, under partial allocation, so long as the amount of deferred taxes is estimated to remain fixed or to increase, no need exists to recognize the tax effects of the initial differences because they probably will not "reverse" in the foreseeable future. Under comprehensive allocation tax effects are recognized as they occur.

Permanent Differences

33. Some differences between taxable income and pretax accounting income are generally referred to as permanent differences. Permanent differences arise from statutory provisions under which specified revenues are exempt from taxation and specified expenses are not allowable as deductions in determining taxable income. (Examples are interest received on municipal obligations and premiums paid on officers' life insurance.) Other permanent differences arise from items entering into the determination of taxable income which are not components of pretax accounting income in any period. (Examples are the special deduction for certain dividends received and the excess of statutory depletion over cost depletion.)

Opinion

34. The Board has considered the various concepts of accounting for income taxes and has concluded that comprehensive interperiod tax allocation is an integral part of the determination of income tax expense. Therefore, income tax expense should include the tax effects of revenue and expense transactions included in the determination of pretax accounting income. The tax effects of those transactions which enter into the determination of pretax accounting income either earlier or later than they become determinants of taxable income should be recognized in the periods in which the differences between pretax accounting income and taxable income arise and in the periods in which the differences reverse. Since permanent differences do not affect other periods, interperiod tax allocation is not appropriate to account for such differences.

35. The Board has concluded that the deferred method [10] of tax allocation should be followed since it provides the most useful and practical approach to interperiod tax allocation and the presentation of income taxes in financial statements.

36. The tax effect of a timing difference should be measured by the differential between income taxes computed with and without inclusion of the transaction creating the difference between taxable income and pretax accounting income. The resulting income tax expense for the period includes the tax effects of transactions entering into the determination of results of operations for the period. The resulting deferred tax amounts reflect the tax effects which will reverse in future periods. The measurement of income tax expense becomes thereby a consistent and integral part of the process of matching revenues and expenses in the determination of results of operations.

37. In computing the tax effects referred to in paragraph 36, timing differences may be considered individually or similar timing differences may be grouped. The net change in deferred taxes for a period for a group of similar timing differences may be determined on the basis of either (a) a combination of amounts representing the tax effects arising from timing differences originating in the period at the current tax rates and reversals of tax effects arising from timing

[10] See paragraph 19.

differences originating in prior periods at the applicable tax rates reflected in the accounts as of the beginning of the period; or (b) if the applicable deferred taxes have been provided in accordance with this Opinion on the cumulative timing differences as of the beginning of the period, the amount representing the tax effects at the current tax rates of the net change during the period in the cumulative timing differences. If timing differences are considered individually, or if similar timing differences are grouped, no recognition should be given to the reversal of tax effects arising from timing differences originating prior to the effective date of this Opinion unless the applicable deferred taxes have been provided for in accordance with this Opinion, either during the periods in which the timing differences originated or, retroactively, as of the effective date of this Opinion. The method or methods adopted should be consistently applied.

Special Areas Requiring Further Study

38. A number of other transactions have tax consequences somewhat similar to those discussed for timing differences. These transactions result in differences between taxable income and pretax accounting income in a period and, therefore, create a situation in which tax allocation procedures may be applicable in the determination of results of operations. These transactions are also characterized by the fact that the tax consequences of the initial differences between taxable income and pretax accounting income may not reverse until an indefinite future period, or conceivably some may never reverse. In addition, each of these transactions has certain unique aspects which create problems in the measurement and recognition of their tax consequences. These special areas are:

a. Undistributed earnings of subsidiaries.
b. Intangible development costs in the oil and gas industry.
c. "General reserves" of stock savings and loan associations.
d. Amounts designated as "policyholders' surplus" by stock life insurance companies.
e. Deposits in statutory reserve funds by United States steamship companies.

39. Paragraph 16 of ARB No. 51, *Consolidated Financial Statements,* states that:

"When separate income tax returns are filed, income taxes usually are incurred when earnings of subsidiaries are transferred to the parent. Where it is reasonable to assume that a part or all of the undistributed earnings of a subsidiary will be transferred to the parent in a taxable distribution, provision for related income taxes should be made on an estimated basis at the time the earnings are included in consolidated income, unless these taxes are immaterial in amount when effect is given, for example, to dividend-received deductions or foreign tax credits. There is no need to provide for income tax to the parent company in cases where the income has been, or there is evidence that it will be, permanently invested by the subsidiaries, or where the only likely distribution would be in the form of a tax-free liquidation."

The Board has decided to defer any modification of the above position until the accounting research study on accounting for intercorporate investments is completed and an Opinion is issued on that subject.

40. Intangible development costs in the oil and gas industry are commonly deducted in the determination of taxable income in the period in which the costs are incurred. Usually the costs are capitalized for financial accounting purposes and are amortized over the productive periods of the related wells. A question exists as to whether the tax effects of the current deduction of these costs for tax purposes should be deferred and amortized over the productive periods of the wells to which the costs relate. Other items have a similar, or opposite, effect because of the interaction with "percentage" depletion for income tax purposes. The Board has decided to defer any conclusion on these questions until the accounting research study on extractive industries is completed and an Opinion is issued on that subject.

41. The "general reserves" of stock savings and loan associations, amounts designated as "policyholders' surplus" by stock life insurance companies and deposits in statutory reserve funds by United States steamship companies each have certain unique aspects concerning the events or conditions which may lead to reversal of the initial tax consequences. The Board has decided to defer any conclusion as to whether interperiod tax allocation should be required in these special areas, pending further study and consideration with a view to issuing Opinions on these areas at a later date.

OPERATING LOSSES

Discussion

42. An operating loss arises when, in the determination of taxable income, deductions exceed revenues. Under applicable tax laws and regulations, operating losses of a period may be carried backward or forward for a definite period of time to be applied as a reduction in computing taxable income, if any, in those periods. When an operating loss is so applied, pretax accounting income and taxable income (after deducting the operating loss carry*back* or carry*forward*) will differ for the period to which the loss is applied.

43. If operating losses are carried backward to earlier periods under provisions of the tax law, the tax effects of the loss carry*backs* are included in the results of operations of the loss period, since realization is assured. If operating losses are carried forward under provisions of the tax law, the tax effects usually are not recognized in the accounts until the periods of realization, since realization of the benefits of the loss carry*forwards* generally is not assured in the loss periods. The only exception to that practice occurs in unusual circumstances when realization is assured beyond any reasonable doubt in the loss periods. Under an alternative view, however, the tax effects of loss carry*forwards* would be recognized in the loss periods unless specific reasons exist to question their realization.

Opinion

44. The tax effects of any realizable loss carry*backs* should be recognized in the determination of net income (loss) of the loss periods. The tax loss gives rise to a refund (or claim for refund) of past taxes, which is both measurable and currently realizable; therefore the tax effect of the loss is properly recognizable in the determination of net income (loss) for the loss period. Appropriate adjustments of existing net deferred tax credits may also be necessary in the loss period.

45. The tax effects of loss carry*forwards* also relate to the determination of net income (loss) of the loss periods. However, a significant question generally exists as to realization of the tax effects of the carry*forwards,* since realization is dependent upon future taxable income. Accordingly, the Board has concluded that the tax benefits of loss carry*forwards* should not be recognized until they are actually realized, except in unusual circumstances when realization is *assured beyond any reasonable doubt* at the time the loss carry*forwards* arise. When the tax benefits of loss carry*forwards* are not recognized until realized in full or in part in subsequent periods, the tax benefits should be reported in the results of operations of those periods as extraordinary items.[11]

46. In those rare cases in which realization of the tax benefits of loss carry*forwards* is assured beyond any reasonable doubt, the potential benefits should be associated with the periods of loss and should be recognized in the determination of results of operations for those periods. Realization is considered to be assured beyond any reasonable doubt when conditions such as those set forth in paragraph 47 are present. (Also see paragraph 48.) The amount of the asset (and the tax effect on results of operations) recognized in the loss period should be computed at the rates expected[12] to be in effect at the time of realization. If the applicable tax rates change from those used to measure the tax effect at the time of recognition, the effect of the rate change should be accounted for in the period of the change as an adjustment of the asset account and of income tax expense.

47. Realization of the tax benefit of a loss carry*forward* would appear to be assured beyond any reasonable doubt when both of the following conditions exist: (a) the loss results from an identifiable, isolated and nonrecurring cause and the company either has been continuously profitable over a long period or has suffered occasional losses which were more than offset by taxable income in subsequent years, and (b) future taxable income is virtually certain to be large enough to offset the loss carry*forward* and will occur soon enough to provide realization during the carry*forward* period.

48. Net deferred tax credits arising from timing differences may exist at the time loss carry*forwards* arise. In the usual case when the tax effect of a loss carry*forward* is not recognized in the loss period, adjustments of the existing net deferred tax credits may be necessary in that period or in subsequent periods. In this situation net deferred tax credits should be eliminated to the extent

[11] See APB Opinion No. 9, *Reporting the Results of Operations.*

[12] The rates referred to here are those rates which, at the time the loss carry*forward* benefit is recognized for financial accounting purposes, have been enacted to apply to appropriate future periods.

of the lower of (a) the tax effect of the loss carry*forward*, or (b) the amortization of the net deferred tax credits that would otherwise have occurred during the carry*forward* period. If the loss carry*forward* is realized in whole or in part in periods subsequent to the loss period, the amounts eliminated from the deferred tax credit accounts should be reinstated (at the then current tax rates) on a cumulative basis as, and to the extent that, the tax benefit of the loss carry*forward* is realized. In the unusual situation in which the tax effect of a loss carry*forward* is recognized as an asset in the loss year,[13] the deferred tax credit accounts would be amortized in future periods as indicated in paragraph 19.

49. The tax effects of loss carry*forwards* of purchased subsidiaries (if not recognized by the subsidiary prior to purchase) should be recognized as assets at the date of purchase only if realization is assured beyond any reasonable doubt. Otherwise they should be recognized only when the tax benefits are actually realized and should be recorded as retroactive adjustments[14] of the purchase transactions and treated in accordance with the procedures described in paragraphs 7 and 8 of ARB No. 51, *Consolidated Financial Statements*. Retroactive adjustments of results of operations for the periods subsequent to purchase may also be necessary if the balance sheet items affected have been subject to amortization in those periods.

50. Tax effects of loss carry*forwards* arising prior to a quasi-reorganization (including for this purpose the application of a deficit in retained earnings to contributed capital) should, if not previously recognized, be recorded as assets at the date of the quasi-reorganization only if realization is assured beyond any reasonable doubt. If not previously recognized and the benefits are actually realized at a later date, the tax effects should be added to contributed capital because the benefits are attributable to the loss periods prior to the quasi-reorganization.

TAX ALLOCATION WITHIN A PERIOD

Discussion

51. The need for tax allocation within a period arises because items included in the determination of taxable income may be presented for accounting purposes as (a) extraordinary items, (b) adjustments of prior periods (or of the opening balance of retained earnings) or (c) as direct entries to other stockholders' equity accounts.

Opinion

52. The Board has concluded that tax allocation within a period should be applied to obtain an appropriate relationship between income tax expense and (a) income before extraordinary items, (b) extraordinary items, (c) adjustments of prior periods (or of the opening balance of retained earnings) and (d) direct entries to other stockholders' equity accounts. The income tax expense attributable to income before extraordinary items is computed by determining the income tax expense related to revenue and expense transactions entering into the determination of such income, without giving effect to the tax consequences of the items excluded from the determination of income before extraordinary items. The income tax expense attributable to other items is determined by the tax consequences of transactions involving these items. If an operating loss exists before extraordinary items, the tax consequences of such loss should be associated with the loss.

OTHER UNUSED DEDUCTIONS AND CREDITS

Opinion

53. The conclusions of this Opinion, including particularly the matters discussed in paragraphs 42-50 on tax reductions resulting from operating losses, also apply to other unused deductions and credits for tax purposes that may be carried backward or forward in determining taxable income (for example, capital losses, contribution carryovers, and foreign tax credits).

FINANCIAL REPORTING

Discussion

Balance Sheet

54. Interperiod tax allocation procedures result in the recognition of several deferred tax accounts. Classification of deferred taxes in the balance sheet has varied in practice, with the accounts reported, alternatively, as follows:

[13] See paragraph 46.

[14] See APB Opinion No. 9, *Reporting the Results of Operations*.

a. *Separate current and noncurrent amounts.* In this form of presentation all balance sheet accounts resulting from income tax allocation are classified into four separate categories—current assets, noncurrent assets, current liabilities and noncurrent liabilities.

b. *Net current and net noncurrent amounts.* In this form of presentation all balance sheet accounts resulting from income tax allocation are classified into two categories—net current amount and net noncurrent amount.

c. *Single amount.* In this form of presentation all balance sheet accounts resulting from income tax allocation are combined in a single amount.

d. *Net of tax presentation.* Under this approach each balance sheet tax allocation account (or portions thereof) is reported as an offset to, or a valuation of, the asset or liability that gave rise to the tax effect. Net of tax presentation is an extension of a valuation concept and treats the tax effects as valuation adjustments of the related assets and liabilities.

Income Statement

55. Interperiod tax allocation procedures result in income tax expense generally different from the amount of income tax payable for a period. Three alternative approaches have developed for reporting income tax expense:

a. *Combined amount.* In this presentation income tax expense for the period is reported as a single amount, after adjustment of the amount of income taxes payable for the period for the tax effects of those transactions which had different effects on pretax accounting income and on taxable income. This form of presentation emphasizes that income tax expense for the period is related to those transactions entering into the determination of pretax accounting income.

b. *Combined amount plus disclosure (or two or more separate amounts).* In this presentation the amount of income taxes reported on the tax return is considered significant additional information for users of financial statements. The amount of taxes payable (or the effect of tax allocation for the period) is, therefore, disclosed parenthetically or in a note to the financial statements. Alternatively, income tax expense may be disclosed in the income statement by presenting separate amounts—the taxes payable and the effects of tax allocation.

c. *"Net of tax" presentation.* Under the "net of tax" concept the tax effects recognized under interperiod tax allocation are considered to be valuation adjustments to the assets or liabilities giving rise to the adjustments. For example, depreciation deducted for tax purposes in excess of that recognized for financial accounting purposes is held to reduce the future utility of the related asset because of a loss of a portion of future tax deductibility. Thus, depreciation expense, rather than income tax expense, is adjusted for the tax effect of the difference between the depreciation amount used in the determination of taxable income and that used in the determination of pretax accounting income.

Opinion

Balance Sheet

56. Balance sheet accounts related to tax allocation are of two types:

a. Deferred charges and deferred credits relating to timing differences; and

b. Refunds of past taxes or offsets to future taxes arising from the recognition of tax effects of carry*backs* and carry*forwards* of operating losses and similar items.

57. Deferred charges and deferred credits relating to timing differences represent the cumulative recognition given to their tax effects and as such do not represent receivables or payables in the usual sense. They should be classified in two categories—one for the net current amount and the other for the net noncurrent amount. This presentation is consistent with the customary distinction between current and noncurrent categories and also recognizes the close relationship among the various deferred tax accounts, all of which bear on the determination of income tax expense. The current portions of such deferred charges and credits should be those amounts which relate to assets and liabilities classified as current. Thus, if installment receivables are a current asset, the deferred credits representing the tax effects of uncollected installment sales should be a current item; if an estimated provision for warranties is a current liability, the deferred charge representing the tax effect of such provision should be a current item.

58. Refunds of past taxes or offsets to future taxes arising from recognition of the tax effects of operating loss carry*backs* or carry*forwards* should be classified either as current or noncurrent. The current portion should be determined by the extent to which realization is expected to occur during the current operating cycle as defined in Chapter 3A of ARB No. 43.

59. Deferred taxes represent tax effects recognized in the determination of income tax expense in current and prior periods, and they should, therefore, be excluded from retained earnings or from any other account in the stockholders' equity section of the balance sheet.

Income Statement

60. In reporting the results of operations the components of income tax expense for the period should be disclosed, for example:

a. Taxes estimated to be payable

b. Tax effects of timing differences

c. Tax effects of operating losses.

These amounts should be allocated to (a) income before extraordinary items and (b) extraordinary items and may be presented as separate items in the income statement or, alternatively, as combined amounts with disclosure of the components parenthetically or in a note to the financial statements.

61. When the tax benefit of an operating loss carry*forward* is realized in full or in part in a subsequent period, and has not been previously recognized in the loss period, the tax benefit should be reported as an extraordinary item [15] in the results of operations of the period in which realized.

62. Tax effects attributable to adjustments of prior periods (or of the opening balance of retained earnings) and direct entries to other stockholders' equity accounts should be presented as adjustments of such items with disclosure of the amounts of the tax effects.[15]

General

63. Certain other disclosures should be made in addition to those set forth in paragraphs 56-62:

a. Amounts of any operating loss carry*forwards* not recognized in the loss period, together with expiration dates (indicating separately amounts which, upon recognition, would be credited to deferred tax accounts);

b. Significant amounts of any other unused deductions or credits, together with expiration dates; and

c. Reasons for significant variations in the customary relationships between income tax expense and pretax accounting income, if they are not otherwise apparent from the financial statements or from the nature of the entity's business.

The Board recommends that the nature of significant differences between pretax accounting income and taxable income be disclosed.

64. The "net of tax" form of presentation of the tax effects of timing differences should not be used for financial reporting. The tax effects of transactions entering into the determination of pretax accounting income for one period but affecting the determination of taxable income in a different period should be reported in the income statement as elements of income tax expense and in the balance sheet as deferred taxes and not as elements of valuation of assets or liabilities.

EFFECTIVE DATE

65. This Opinion shall be effective for all fiscal periods that begin after December 31, 1967. However, the Board encourages earlier application of the provisions of this Opinion.

66. Accordingly, the tax allocation procedures set forth in this Opinion should be applied to timing differences occurring after the effective date. (See paragraph 37 for treatment of timing differences originating prior to the effective date.) Balance sheet accounts which arose from interperiod tax allocation and accounts stated on a net of tax basis prior to the effective date of this Opinion should be presented in the manner set forth in this Opinion.

67. The Board recognizes that companies may apply this Opinion retroactively to periods prior to the effective date to obtain comparability in financial presentations for the current and future periods. If the procedures are applied retroactively, they should be applied to all material items of those periods insofar as the recognition of prior period tax effects of timing differences, op-

[15] See APB Opinion No. 9, *Reporting the Results of Operations.*

erating losses and other deductions or credits is concerned. Any adjustments made to give retroactive effect to the conclusions stated in this Opinion should be considered adjustments of prior periods and treated accordingly.[16]

The Opinion entitled "Accounting for Income Taxes" was adopted by the assenting votes of fourteen members of the Board, of whom one, Mr. Halvorson, assented with qualification. Messrs. Biegler, Crichley, Davidson, Luper, Queenan and Walker dissented.

Mr. Halvorson assents to the publication of the Opinion, but dissents to the first sentence of paragraph 67 which permits retroactive application. He believes that the recommendations for comprehensive allocation should be applied prospectively and that adjustments that may be required because of timing differences not recognized in years prior to the adoption of comprehensive allocation should be accounted for when the future tax effects occur.

Messrs. Biegler, Davidson and Queenan dissent from this Opinion because they do not agree with the conclusion expressed in paragraph 34 that tax allocation should be applied on a comprehensive basis. They believe, instead, that income tax expense should be determined on the basis of partial allocation, as explained in paragraphs 26 through 28. They believe that to the extent that comprehensive allocation deviates from accrual of income tax reasonably expected to be paid or recovered, it would result (1) in accounts carried as assets which have no demonstrable value and which are never expected to be realized, (2) in amounts carried as liabilities which are mere contingencies and (3) in corresponding charges or credits to income for contingent amounts. In their view, comprehensive allocation shifts the burden of distinguishing between real and contingent costs, assets and liabilities from management and the independent auditor, who are best qualified to make such distinctions, to the users of financial statements.

Messrs. Biegler, Davidson and Queenan further believe that to require classification of deferred taxes as a current asset or current liability, in the circumstances explained in paragraph 57, would contribute to a lack of understanding of working capital, because of the commingling of contingent items with items which are expected to be realized or discharged during the normal operating cycle of a business.

Mr. Queenan also objects to the procedure whereby changes were made in paragraphs 37 and 66 subsequent to the issuance of the ballot draft which, in his opinion, should have had the benefit of open discussion in a Board meeting.

Mr. Luper and Mr. Crichley join in the dissent that has been prepared and submitted by Messrs. Biegler, Davidson and Queenan. In addition, Mr. Luper and Mr. Crichley wish to include the following two paragraphs as additional comments:

Mr. Luper and Mr. Crichley do not concur in paragraph 3 of the Opinion because they believe that it is inappropriate for the Board to issue an Opinion requiring comprehensive tax allocation, which will result in contingent long-term deferred debits and/or credits, without first completing its study and resolving the question of discounting deferred amounts to current value.

Finally, Mr. Luper and Mr. Crichley believe that substantial authoritative support exists for the concept of partial tax allocation, as evidenced by statements of corporate financial executives, independent practicing accountants, and accounting academicians and by the current accounting practices of a significant number of companies. This concept is presently embodied in ARB No. 43, Chapter 10, Section B, which states that tax allocation does not apply where there is a presumption that particular differences between the tax return and the income statement will recur regularly over a comparatively long period of time. Consequently, they believe the prescription of the concept of comprehensive tax allocation is premature until there is greater evidence of the general acceptability of the comprehensive concept.

Mr. Walker believes the so-called comprehensive allocation of material items to be the preferred treatment; however, with the disclosure of the general bases used, it should be permissive to consistently use partial allocation as explained in paragraphs 26 through 28 and the financial presentations described in paragraphs 54 and 55.

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[16] See APB Opinion No. 9, *Reporting the Results of Operations.*

NOTES

Opinions present the considered opinion of at least two-thirds of the members of the Accounting Principles Board, reached on a formal vote after examination of the subject matter.

Except as indicated in the succeeding paragraph, the authority of the Opinions rests upon their general acceptability. While it is recognized that general rules may be subject to exception, the burden of justifying departures from Board Opinions must be assumed by those who adopt other practices.

Action of Council of the Institute (Special Bulletin, Disclosure of Departures From Opinions of Accounting Principles Board, *October 1964) provides that:*

a. *"Generally accepted accounting principles" are those principles which have substantial authoritative support.*

b. *Opinions of the Accounting Principles Board constitute "substantial authoritative support".*

c. *"Substantial authoritative support" can exist for accounting principles that differ from Opinions of the Accounting Principles Board.*

The Council action also requires that departures from Board Opinions be disclosed in footnotes to the financial statements or in independent auditors' reports when the effect of the departure on the financial statements is material.

Unless otherwise stated, Opinions of the Board are not intended to be retroactive. They are not intended to be applicable to immaterial items.

Accounting Principles Board (1966-1967)

CLIFFORD V. HEIMBUCHER *Chairman*	W. A. CRICHLEY	ORAL L. LUPER
MARSHALL S. ARMSTRONG	JOSEPH P. CUMMINGS	JOHN K. MCCLARE
DONALD J. BEVIS	SIDNEY DAVIDSON	ROBERT J. MURPHEY
JOHN C. BIEGLER	PHILIP L. DEFLIESE	LOUIS H. PENNEY
MILTON M. BROEKER	WALTER F. FRESE	JOHN W. QUEENAN
GEORGE R. CATLETT	NEWMAN T. HALVORSON	WILBERT A. WALKER
	LEROY LAYTON	FRANK T. WESTON

APPENDIX A

Examples of Timing Differences

The following examples of timing differences are taken from Accounting Research Study No. 9, *Interperiod Allocation of Corporate Income Taxes,* by Homer A. Black, pages 8-10. They are furnished for illustrative purposes only without implying approval by the Board of the accounting practices described.

(A) *Revenues or gains are taxed after accrued for accounting purposes:*

Profits on installment sales are recorded in accounts at date of sale and reported in tax returns when later collected.

Revenues on long-term contracts are recorded in accounts on percentage-of-completion basis and reported in tax returns on a completed-contract basis.

Revenue from leasing activities is recorded in a lessor's accounts based on the financing method of accounting and exceeds rent less depreciation reported in tax returns in the early years of a lease.

Earnings of foreign subsidiary companies are recognized in accounts currently and included in tax returns when later remitted.

(B) *Expenses or losses are deducted for tax purposes after accrued for accounting purposes:*

Estimated costs of guarantees and product warranty contracts are recorded in accounts at date of sale and deducted in tax returns when later paid.

Expenses for deferred compensation, profit-sharing, bonuses, and vacation and severance pay are recorded in accounts when accrued for the applicable period and deducted in tax returns when later paid.

Expenses for pension costs are recorded in accounts when accrued for the applicable period and deducted in tax returns for later periods when contributed to the pension fund.

Current expenses for self-insurance are recorded in accounts based on consistent computations for the plan and deducted in tax returns when losses are later incurred.

Estimated losses on inventories and purchase commitments are recorded in accounts when reasonably anticipated and deducted in tax returns when later realized.

Estimated losses on disposal of facilities and discontinuing or relocating operations are recorded in accounts when anticipated and determinable and deducted in tax returns when losses or costs are later incurred.

Estimated expenses of settling pending lawsuits and claims are recorded in accounts when reasonably ascertainable and deducted in tax returns when later paid.

Provisions for major repairs and maintenance are accrued in accounts on a systematic basis and deducted in tax returns when later paid.

Depreciation recorded in accounts exceeds that deducted in tax returns in early years because of:

accelerated method of computation for accounting purposes

shorter lives for accounting purposes

Organization costs are written off in accounts as incurred and amortized in tax returns.

(C) *Revenues or gains are taxed before accrued for accounting purposes:*

Rent and royalties are taxed when collected and deferred in accounts to later periods when earned.

Fees, dues, and service contracts are taxed when collected and deferred in accounts to later periods when earned.

Profits on intercompany transactions are taxed when reported in separate returns, and those on assets remaining within the group are eliminated in consolidated financial statements.

Gains on sales of property leased back are taxed at date of sale and deferred in accounts and amortized during the term of lease.

Proceeds of sales of oil payments or ore payments are taxed at date of sale and deferred in accounts and recorded as revenue when produced.

(D) *Expenses or losses are deducted for tax purposes before accrued for accounting purposes:*

Depreciation deducted in tax returns exceeds that recorded in accounts in early years because of:

accelerated method of computation for tax purposes

shorter guideline lives for tax purposes

amortization of emergency facilities under certificates of necessity

Unamortized discount, issue cost and redemption premium on bonds refunded are deducted in tax returns and deferred and amortized in accounts.

Research and development costs are deducted in tax returns when incurred and deferred and amortized in accounts.

Interest and taxes during construction are deducted in tax returns when incurred and included in the cost of assets in accounts.

Preoperating expenses are deducted in tax returns when incurred and deferred and amortized in accounts.

APB Opinion No. 12

OMNIBUS OPINION—1967

DECEMBER, 1967

Classification and Disclosure of Allowances
Disclosure of Depreciable Assets and Depreciation
Deferred Compensation Contracts
Capital Changes
Convertible Debt and Debt Issued with Stock Warrants
Amortization of Debt Discount and Expense or Premium

INTRODUCTION

1. This is the second of a series of Opinions which the Board expects to issue periodically containing:

(a) Amendments of prior Opinions of the Accounting Principles Board and Accounting Research Bulletins of its predecessor, the committee on accounting procedure, as appear necessary to clarify their meaning or to describe their applicability under changed conditions.

(b) Affirmation of accounting principles and methods which have become generally accepted through practice and which the Board believes to be sound, and when it desires to prevent the possible development of less desirable alternatives.

(c) Conclusions as to appropriate accounting principles and methods on subjects not dealt with in previous pronouncements and for which a separate Opinion is not believed to be warranted.

CLASSIFICATION AND DISCLOSURE OF ALLOWANCES

2. Although it is generally accepted that accumulated allowances for depreciation and depletion and asset valuation allowances for losses such as those on receivables and investments should be deducted from the assets to which they relate, there are instances in which these allowances are shown among liabilities or elsewhere on the credit side of the balance sheet.

3. It is the Board's opinion that such allowances should be deducted from the assets or groups of assets to which the allowances relate, with appropriate disclosure.

DISCLOSURE OF DEPRECIABLE ASSETS AND DEPRECIATION

4. Disclosure of the total amount of depreciation expense entering into the determination of results of operations has become a general practice. The balances of major classes of depreciable assets are also generally disclosed. Practice varies, however, with respect to disclosure of the depreciation method or methods used.

5. Because of the significant effects on financial position and results of operations of the depreciation method or methods used, the following disclosures should be made in the financial statements or in notes thereto:

a. Depreciation expense for the period,

b. Balances of major classes of depreciable assets, by nature or function, at the balance-sheet date,

c. Accumulated depreciation, either by major classes of depreciable assets or in total, at the balance-sheet date, and

d. A general description of the method or methods used in computing depreciation with respect to major classes of depreciable assets.

DEFERRED COMPENSATION CONTRACTS

6. APB Opinion No. 8, *Accounting for the Cost of Pension Plans,* applies to deferred compensation contracts with individual employees if such contracts, taken together, are equivalent to a pension plan. The Board believes that other deferred compensation contracts should be accounted for individually on an accrual basis. Such contracts customarily include certain requirements such as continued employment for a specified period and availability for consulting services and agreements not to compete after retirement, which, if not complied with, remove the employer's obligations for future payments. The estimated amounts[1] to be paid under each contract should be accrued in a systematic and rational manner over the period of active employment from the time the contract is entered into, unless it is evident that future services expected to be received by the employer are commensurate with the payments or a portion of the payments to be made. If elements of both current and future services are present, only the portion applicable to the current services should be accrued.

7. Some deferred compensation contracts provide for periodic payments to employees or their surviving spouses for life with provisions for a minimum lump-sum settlement in the event of the early death of one or all of the beneficiaries. The estimated amount[1] of future payments to be made under such contracts should be accrued over the period of active employment from the time the contract is entered into. Such estimates should be based on the life expectancy of each individual concerned (based on the most recent mortality tables available) or on the estimated cost of an annuity contract rather than on the minimum payable in the event of early death.

8. At the effective date of this Opinion, amounts[1] pertaining to deferred compensation contracts with employees actively employed, which amounts have not been accrued in a manner consistent with the provisions of the Opinion, should be accrued over the employee's remaining term of active employment. For purposes of transition, these amounts may be accrued over a period of up to ten years if the remaining term of active employment is less than ten years.

CAPITAL CHANGES

9. Paragraph 7 of APB Opinion No. 9, *Reporting the Results of Operations,* states that "The statement of income and the statement of retained earnings (separately or combined) are designed to reflect, in a broad sense, the 'results of operations'." Paragraph 28 of APB Opinion No. 9 states that certain capital transactions ". . . should be excluded from the determination of net income or the results of operations under all circumstances." Companies generally have reported the current year's changes in stockholders' equity accounts other than retained earnings in separate statements or notes to the financial statements when presenting both financial position and results of operations for one or more years. A question has arisen as to whether, because of the language of APB Opinion No. 9, changes in stockholders' equity accounts other than retained earnings are required to be reported.

10. When both financial position and results of operations are presented, disclosure of changes in the separate accounts comprising stockholders' equity (in addition to retained earnings) and of the changes in the number of shares of equity securities during at least the most recent annual fiscal period and any subsequent interim period presented is required to make the financial statements sufficiently informative. Disclosure of such changes may take the form of separate statements or may be made in the basic financial statements or notes thereto.

CONVERTIBLE DEBT AND DEBT ISSUED WITH STOCK WARRANTS

11. Paragraphs 8 and 9 of APB Opinion No. 10 call for certain accounting treatment, effective for periods beginning after December 31, 1966, for proceeds received for debt securities convertible into stock or issued together with warrants to

[1] The amounts to be accrued periodically should result in an accrued amount at the end of the term of active employment which is not less than the then present value of the estimated payments to be made.

purchase stock. Since the issuance of that Opinion, the Board has observed developments in the use of securities of this character and experiences in the application of those paragraphs of the Opinion. In addition, the Board has received views of interested parties relative to the nature of these securities and the problems in implementing the paragraphs. These observations and views have suggested that because certain aspects of these instruments, particularly in the case of convertible debentures, raise difficult estimation and other problems, further study is needed in this area. Also, because of the actual or potential equity nature of these instruments, the relationship between the accounting for the proceeds and the treatment of "residual" securities in the determination of earnings per share has created problems which need to be studied further. For these reasons, the Board is temporarily suspending the effectiveness of paragraphs 8 and 9 of Opinion No. 10 retroactively to their effective date.

12. In the meantime, the Board is studying further the accounting treatment of the various types of convertible and participating securities in relation to the determination of results of operations and earnings per share, including the residual aspects of such securities, and plans to issue a separate Opinion on this subject by December 31, 1968. It should be noted, however, that some issues of convertible debt securities may presently be residual securities and should be treated as such for the purpose of determining earnings per share as provided in paragraph 33 of APB Opinion No. 9, regardless of the suspension referred to above.

13. Pending issuance of the new Opinion, the accounting treatment set forth in paragraphs 8 and 9 of Opinion No. 10 is considered to be an acceptable practice.

14. Since the paragraphs being suspended were effective for fiscal periods beginning after December 31, 1966, the Board may decide to have the new Opinion effective on a retroactive basis for such fiscal periods.

15. Those entities which otherwise are or would be subject to the accounting requirements of paragraphs 8 and 9 of Opinion No. 10 (by virtue of having issued, during a fiscal period beginning after December 31, 1966, convertible debt or debt with stock warrants) may elect, as a result of this suspension, not to adopt such accounting treatment. If an entity so elects, the Board has concluded that, until issuance of its Opinion with respect to the treatment of such securities, a dual presentation of earnings per share of common stock should be furnished on the face of the statement of income. This dual presentation should disclose (a) earnings per share computed in accordance with Opinion No. 9, based on average shares outstanding during the period and (b) earnings per share computed on the assumption that *all* conversions and contingent issuances[3] had taken place. (The bases for each of these computations should be disclosed.) These computations should be described somewhat as follows:

Earnings per share of common stock—	
Based on average shares outstanding during the period	\$X.XX
Based on assumption of conversion or exercise of all outstanding convertible securities, options and warrants	\$X.XX

The purpose of the dual presentation is to recognize and emphasize the complex nature of these securities, including the existence of equity security characteristics, and the possibility that conversion of the security or exercise of options or of warrants may affect earnings per share of common stock. In addition, disclosure should be made that the provisions of the proposed new Opinion may be required to be applied retroactively in financial statements for fiscal periods beginning after December 31, 1966. Such disclosure should include an estimate, if reasonably determinable, of the effect upon net income of retroactive application of paragraphs 8 and 9 of Opinion No. 10. This disclosure should be made in total and on a per-share basis.

Messrs. Armstrong and Layton concur with the temporary suspension of paragraphs 8 and 9 of Opinion No. 10, but do not agree with paragraph 14 and the disclosures required in the last three sentences of paragraph 15 above, since they believe that retroactive application of any new Opinion on the subject should not be required. They therefore object to the disclosures implying the possibility of retroactive application and further believe that such disclosures will create unnecessary uncertainties in the minds of readers of financial statements.

[3] See Opinion No. 9, paragraph 43.

Mr. Halvorson concurs with paragraphs 11, 12, and 13 suspending the effectiveness of paragraphs 8 and 9 of APB Opinion No. 10, but he believes the suspension should be unconditional and therefore disagrees with paragraph 14 implying retroactive application of a new Opinion and with paragraph 15 attaching conditions to the suspension.

Mr. Luper dissents from the section of this Opinion entitled "Convertible Debt and Debt issued with Stock Warrants" (paragraphs 11-15) because he does not agree with the conclusions in paragraphs 14 and 15. He believes that the statement in paragraph 14 that the Board may decide to require retroactive treatment for a new Opinion to be issued in the future establishes an unsound precedent. In his view the Board should not require that its Opinions be accorded retroactive treatment because such action introduces a condition of instability in financial reporting standards—a condition that, from a business viewpoint, is inimical to both those who prepare and those who use financial statements.

Mr. Luper regards the further requirement in paragraph 15 that issuers of financial statements shall state, under the conditions given, that their reported net income and earnings per share may be revised subsequently because of possible conclusions to be included in an Opinion not yet formulated by the Board is an unreasonable intrusion on the responsibilities of such issuers.

AMORTIZATION OF DEBT DISCOUNT AND EXPENSE OR PREMIUM

16. Questions have been raised as to the appropriateness of the "interest" method of periodic amortization of discount and expense or premium on debt (i.e., the difference between the net proceeds, after expense, received upon issuance of debt and the amount repayable at its maturity) over its term. The objective of the interest method is to arrive at a periodic interest cost (including amortization) which will represent a level effective rate on the sum of the face amount of the debt and (plus or minus) the unamortized premium or discount and expense at the beginning of each period. The difference between the periodic interest cost so calculated and the nominal interest on the outstanding amount of the debt is the amount of periodic amortization.

17. In the Board's opinion, the interest method of amortization is theoretically sound and an acceptable method.

EFFECTIVE DATE OF THIS OPINION

18. As indicated in paragraph 11, the effectiveness of paragraphs 8 and 9 of Opinion No. 10 is temporarily suspended retroactively to their effective date. In other respects, this Opinion shall be effective for fiscal periods beginning after December 31, 1967. However, the Board encourages earlier application of the provisions of this Opinion.

All portions of the Opinion entitled "Omnibus Opinion — 1967" were adopted by the twenty members of the Board, except as follows: Messrs. Armstrong and Layton assented with qualification as to paragraph 14 and the last three sentences of paragraph 15 and Mr. Halvorson assented with qualification as to paragraphs 14 and 15. Mr. Luper dissented as to paragraphs 11-15.

NOTES

Opinions present the considered opinion of at least two-thirds of the members of the Accounting Principles Board, reached on a formal vote after examination of the subject matter.

Except as indicated in the succeeding paragraph, the authority of the Opinions rests upon their general acceptability. While it is recognized that general rules may be subject to exception, the burden of justifying departures from Board Opinions must be assumed by those who adopt other practices.

Action of Council of the Institute (Special Bulletin, Disclosure of Departures From Opinions of Accounting Principles Board, *October 1964) provides that:*

a. *"Generally accepted accounting principles" are those principles which have substantial authoritative support.*

b. Opinions of the Accounting Principles Board constitute "substantial authoritative support."

c. "Substantial authoritative support" can exist for accounting principles that differ from Opinions of the Accounting Principles Board.

The Council action also requires that departures from Board Opinions be disclosed in footnotes to the financial statements or in independent auditors' reports when the effect of the departure on the financial statement is material.

Unless otherwise stated, Opinions of the Board are not intended to be retroactive. They are not intended to be applicable to immaterial items.

Accounting Principles Board (1966-1967)

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APB Opinion No. 13

AMENDING PARAGRAPH 6 OF APB OPINION NO. 9, APPLICATION TO COMMERCIAL BANKS

March, 1969

1. In December, 1966 this Board issued Opinion No. 9, *Reporting the Results of Operations.* That Opinion did not apply to financial statements of commercial banks for reasons expressed in the last two sentences of paragraph 6, which stated:

"A committee of the American Institute of Certified Public Accountants is in the process of recommending a format for the income statement of commercial banks. Until such recommendation has been given and until the Board has taken a position thereon, this Opinion is not applicable to commercial banks."

2. The last two sentences of paragraph 6 of APB Opinion No. 9 are deleted and such Opinion as hereby amended is therefore applicable to financial statements issued by commercial banks for fiscal periods beginning after December 31, 1968.

The Opinion entitled "Amending Paragraph 6 of APB Opinion No. 9, Application to Commercial Banks" was adopted unanimously by the eighteen members of the Board.

NOTES

Opinions present the considered opinion of at least two-thirds of the members of the Accounting Principles Board, reached on a formal vote after examination of the subject matter.

Except as indicated in the succeeding paragraph, the authority of the Opinions rests upon their general acceptability. While it is recognized that general rules may be subject to exception, the burden of justifying departures from Board Opinions must be assumed by those who adopt other practices.

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a. "Generally accepted accounting principles" are those principles which have substantial authoritative support.

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The Council action also requires that departures from Board Opinions be disclosed in footnotes to the financial statements or in independent auditors' reports when the effect of the departure on the financial statements is material.

Unless otherwise stated, Opinions of the Board are not intended to be retroactive. They are not intended to be applicable to immaterial items.

APB Opinion No. 14

ACCOUNTING FOR CONVERTIBLE DEBT AND DEBT ISSUED WITH STOCK PURCHASE WARRANTS

MARCH, 1969

INTRODUCTION

1. Paragraphs 8 and 9 of APB Opinion No. 10[1] stated that a portion of the proceeds received for convertible debt or debt issued with stock purchase warrants is ordinarily attributable to the conversion feature or to the warrants and should therefore be accounted for as paid-in capital. Since the issuance of that Opinion, the Board has observed the experiences of issuers of these securities in applying those paragraphs. In addition, interested parties have expressed their views as to the nature of these securities and the problems of implementing the principles discussed in those paragraphs. The observations and views indicated that dealing with certain aspects of these securities, particularly convertible debentures, involved difficult problems which warranted further study. In December 1967, the Board, therefore, temporarily suspended the effectiveness of paragraphs 8 and 9 of APB Opinion No. 10 retroactively to their effective date and established specific requirements for earnings per share data to be included in income statements. (See paragraphs 11 through 15 of APB Opinion No. 12.)

2. Since then the Board has reexamined the characteristics of convertible debt and debt issued with stock purchase warrants to determine whether the accounting called for by paragraphs 8 and 9 of APB Opinion No. 10 should be reinstated. This Opinion results from that study and sets forth the conclusions reached by the Board. Accordingly, this Opinion supersedes paragraphs 8 and 9 of APB Opinion No. 10 and paragraphs 11 through 15 of APB Opinion No. 12.

CONVERTIBLE DEBT

Discussion

3. Convertible debt securities discussed herein are those debt securities which are convertible into common stock of the issuer or an affiliated company at a specified price at the option of the holder and which are sold at a price or have a value at issuance not significantly in excess of the face amount. The terms of such securities generally include (1) an interest rate which is lower than the issuer could establish for nonconvertible debt, (2) an initial conversion price which is greater than the market value of the common stock at time of issuance, and (3) a conversion price which does not decrease except pursuant to antidilution provisions. In most cases such securities also are callable at the option of the issuer and are subordinated to nonconvertible debt.

4. Convertible debt may offer advantages to both the issuer and the purchaser. From the point of view of the issuer, convertible debt has a lower interest rate than does nonconvertible debt. Furthermore, the issuer of convertible debt securities, in planning its long-range financing, may view convertible debt as essentially a means of raising equity capital. Thus, if the market value of the underlying common stock increases sufficiently in the future, the issuer can force conversion of the convertible debt into common stock by calling the issue for redemption. Under these market conditions, the issuer can effectively terminate the conversion option and eliminate the debt. If the market value of the stock does not increase sufficiently to result in conversion of the debt, the issuer will have received the benefit of the cash proceeds to the scheduled maturity dates at a relatively low cash interest cost.

5. On the other hand, the purchaser obtains an option to receive either the face or redemption amount of the security or the number of common shares into which the security is convertible. If the market

[1] Effective for fiscal periods beginning after December 31, 1966.

value of the underlying common stock increases above the conversion price, the purchaser (either through conversion or through holding the convertible debt containing the conversion option) benefits through appreciation. He may at that time require the issuance of the common stock at a price lower than the current market price. However, should the value of the underlying common stock not increase in the future, the purchaser has the protection of a debt security. Thus, in the absence of default by the issuer, he would receive the principal and interest if the conversion option is not exercised.

6. Differences of opinion exist as to whether convertible debt securities should be treated by the issuer solely as debt or whether the conversion option should receive separate accounting recognition at time of issuance. The views in favor of each of these two concepts are contained in the following paragraphs.

7. The most important reason given for accounting for convertible debt solely as debt is the inseparability of the debt and the conversion option. A convertible debt security is a complex hybrid instrument bearing an option, the alternative choices of which cannot exist independently of one another. The holder ordinarily does not sell one right and retain the other. Furthermore the two choices are mutually exclusive; they cannot both be consummated. Thus, the security will either be converted into common stock or be redeemed for cash. The holder cannot exercise the option to convert unless he foregoes the right to redemption, and vice versa.

8. Another reason advanced in favor of accounting for convertible debt solely as debt is that the valuation of the conversion option or the debt security without the conversion option presents various practical problems. In the absence of separate transferability, values are not established in the marketplace, and accordingly, the value assigned to each feature is necessarily subjective. A determination of the value of the conversion feature poses problems because of the uncertain duration of the right to obtain the stock and the uncertainty as to the future value of the stock obtainable upon conversion. Furthermore, issuers often claim that a subjective valuation of a debt security without the conversion option but with identical other terms (which are usually less restrictive on the issuer and less protective of the holder than those of nonconvertible debt) is difficult because such a security could not be sold at a price which the issuer would regard as producing an acceptable cost of financing. Thus, when the attractiveness to investors of a convertible debt security rests largely on the anticipated increased value of the issuer's stock, the conversion feature may be of primary importance, with the debt feature regarded more as a hedge than as the principal investment objective. Many proponents of the single-element view believe that the practical problems of determining separate values for the debt and the conversion option should not be controlling for purposes of determining appropriate accounting but such problems should be given consideration, particularly if valid arguments exist for each of the two accounting concepts identified in paragraph 6.

9. The contrary view is that convertible debt possesses characteristics of both debt and equity and that separate accounting recognition should be given to the debt characteristics and to the conversion option at time of issuance. This view is based on the premise that there is an economic value inherent in the conversion feature or call on the stock and that the nature and value of this feature should be recognized for accounting purposes by the issuer. The conversion feature is not significantly different in nature from the call represented by an option or warrant, and sale of the call is a type of capital transaction. The fact that the conversion feature coexists with certain debt characteristics in a hybrid security and cannot be sold or transferred separately from these senior elements or from the debt instrument itself does not constitute a logical or compelling reason why the values of the two elements should not receive separate accounting recognition. Similar separate accounting recognition for disparate features of single instruments is reflected in, for example, the capitalization of long-term leases—involving the separation of the principal and interest elements—and in the allocation of the purchase cost in a bulk acquisition between goodwill and other assets.

10. Holders of this view also believe that the fact that the eventual outcome of the option available to the purchaser of the convertible debt security cannot be determined at time of issuance is not relevant to the question of reflecting in the accounting records the distinguishable elements of the security at time of issuance. The conversion option has a value at time of issuance, and a portion of the proceeds should therefore be allocated to this element of the transaction. The remainder of the proceeds

is attributable to the debt characteristics, and should be so recognized for accounting purposes.

11. Holders of this view also believe that the difficulties of implementation—which are claimed by some to justify or to support not recognizing the conversion option for accounting purposes—are not insurmountable and should not govern the conclusion. When convertible debt securities are issued, professional advisors are usually available to furnish estimates of values of the conversion option and of the debt characteristics, which values are sufficiently precise for the purpose of allocating the proceeds. If a nonconvertible debt security could not be sold at an acceptable price, the value of the conversion option is of such material significance that its accounting recognition, even on the basis of an estimate, is essential.

Opinion

12. The Board is of the opinion that no portion of the proceeds from the issuance of the types of convertible debt securities described in paragraph 3 should be accounted for as attributable to the conversion feature. In reaching this conclusion, the Board places greater weight on the inseparability of the debt and the conversion option (as described in paragraph 7) and less weight on practical difficulties.

DEBT WITH STOCK PURCHASE WARRANTS

Discussion

13. Unlike convertible debt, debt with detachable warrants to purchase stock is usually issued with the expectation that the debt will be repaid when it matures. The provisions of the debt agreement are usually more restrictive on the issuer and more protective of the investor than those for convertible debt. The terms of the warrants are influenced by the desire for a successful debt financing. Detachable warrants often trade separately from the debt instrument. Thus, the two elements of the security exist independently and may be treated as separate securities.

14. From the point of view of the issuer, the sale of a debt security with warrants results in a lower cash interest cost than would otherwise be possible or permits financing not otherwise practicable. The issuer usually cannot force the holders of the warrants to exercise them and purchase the stock. The issuer may, however, be required to issue shares of stock at some future date at a price lower than the market price existing at that time, as is true in the case of the conversion option of convertible debt. Under different conditions the warrants may expire without exercise. The outcome of the warrant feature thus cannot be determined at time of issuance. In either case the debt must generally be paid at maturity or earlier redemption date whether or not the warrants are exercised.

15. There is general agreement among accountants that the proceeds from the sale of debt with stock purchase warrants should be allocated to the two elements for accounting purposes. This agreement results from the separability of the debt and the warrants. The availability of objective values in many instances is also a factor. There is agreement that the allocation should be based on the relative fair values of the debt security without the warrants and of the warrants themselves at time of issuance. The portion of the proceeds so allocated to the warrants should be accounted for as paid-in capital. The remainder of the proceeds should be allocated to the debt security portion of the transaction. This usually results in issuing the debt security at a discount (or, occasionally, a reduced premium).

Opinion

16. The Board is of the opinion that the portion of the proceeds of debt securities issued with detachable stock purchase warrants which is allocable to the warrants should be accounted for as paid-in capital. The allocation should be based on the relative fair values of the two securities at time of issuance.[2] Any resulting discount or premium on the debt securities should be accounted for as such.[3] The same accounting treatment applies to issues of debt securities (issued with detachable warrants) which may be surrendered in settlement of the exercise price of the warrant. However, when stock purchase warrants are not detachable from the debt and the debt security must be surrendered in order to exercise the warrant, the two securities taken together

[2] The time of issuance generally is the date when agreement as to terms has been reached and announced, even though the agreement is subject to certain further actions, such as directors' or stockholders' approval.

[3] See Chapter 15 of ARB No. 43 (as amended by paragraph 19 of APB Opinion No. 6 and paragraph 17 of APB Opinion No. 9) and paragraphs 16 and 17 of APB Opinion No. 12.

are substantially equivalent to convertible debt and the accounting specified in paragraph 12 should apply.

17. When detachable warrants are issued in conjunction with debt as consideration in purchase transactions, the amounts attributable to each class of security issued should be determined separately, based on values at the time of issuance.[3] The debt discount or premium is obtained by comparing the value attributed to the debt securities with the face amount thereof.

OTHER TYPES OF DEBT SECURITIES

Opinion

18. The Board recognizes that it is not practicable in this Opinion to discuss all possible types of debt with conversion features, debt issued with stock purchase warrants, or debt securities with a combination of such features. Securities not explicitly discussed in this Opinion should be dealt with in accordance with the substance of the transaction. For example, when convertible debt is issued at a substantial premium, there is a presumption that such premium represents paid-in capital.

EFFECTIVE DATE OF THIS OPINION

19. This Opinion is effective for fiscal periods beginning after December 31, 1966.[4] However, if a portion of the proceeds of a convertible debt issue covered by paragraph 12 was allocated to the conversion feature for periods beginning before January 1, 1969 that accounting may be continued with respect to such issues.

20. Material adjustments resulting from adoption of this Opinion which affect periods beginning prior to January 1, 1969 should be treated as prior period adjustments (see paragraphs 23 and 25 of APB Opinion No. 9).

The Opinion entitled "Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants" was adopted by the assenting votes of fourteen members of the Board, of whom two, Messrs. Halvorson and Luper, assented with qualification. Messrs. Cummings, Davidson, Seidman and Weston dissented.

Mr. Halvorson assents to the publication of the Opinion, but dissents to paragraph 19 insofar as it requires the recommended accounting for detachable warrants to be made retroactive to January 1, 1967, and also dissents to paragraph 12 because he believes that, as a matter of principle, there are circumstances under which an issuer should be permitted, or even required, to account for a part of the proceeds of convertible debt as being attributable to the conversion feature.

Mr. Luper assents to the issuance of this Opinion but dissents to paragraph 19 which makes this Opinion effective for fiscal periods beginning after December 31, 1966. He believes that it is unsound for the Board to require that an Opinion be applied retroactively because such requirement causes a condition of instability in financial reporting standards.

Messrs. Cummings, Davidson, Seidman, and Weston dissent from the conclusion set forth in paragraph 12 of this Opinion, for the reasons set forth in paragraphs 9 through 11. They believe that, by ignoring the value of the conversion privilege and instead using as a measure solely the coupon rate of interest, the Opinion specifies an accounting treatment which does not reflect the true interest cost. The resulting error can be demonstrated by comparing the simultaneous sale of debt securities by two issuers—one with a prime credit rating, so that it can obtain financing by means of non-convertible debt; the other with an inferior credit rating, so that it can obtain financing at an acceptable rate only by means of a conversion option added to its debt. The coupon rate of interest on the debt of the prime rated issuer may be the same as, or higher than, the rate on the convertible debt of the other issuer. To conclude under these conditions,

[3] The time of issuance generally is the date when agreement as to terms has been reached and announced, even though the agreement is subject to certain further actions, such as directors' or stockholders' approval.

[4] This was the effective date of paragraphs 8 and 9 of APB Opinion No. 10 which were temporarily suspended by paragraphs 11-15 of APB Opinion No. 12. The latter Opinion stated that the Board might decide to have the Opinion resolving this question apply retroactively to fiscal periods beginning after December 31, 1966.

as the Opinion does, that the cost of this financing for the prime rated issuer is equal to or greater than that of the inferior rated issuer is to belie economic reality. Furthermore, while the debt obligation and the conversion feature coexist in a hybrid instrument, such fact is not a logical reason for failing to account separately for their individual values.

NOTES

Opinions present the considered opinion of at least two-thirds of the members of the Accounting Principles Board, reached on a formal vote after examination of the subject matter.

Except as indicated in the succeeding paragraph, the authority of the Opinions rests upon their general acceptability. While it is recognized that general rules may be subject to exception, the burden of justifying departures from Board Opinions must be assumed by those who adopt other practices.

Action of Council of the Institute (Special Bulletin, Disclosure of Departures from Opinions of Accounting Principles Board, *October, 1964) provides that:*

a. *"Generally accepted accounting principles" are those principles which have substantial authoritative support.*

b. *Opinions of the Accounting Principles Board constitute "substantial authoritative support".*

c. *"Substantial authoritative support" can exist for accounting principles that differ from Opinions of the Accounting Principles Board.*

The Council action also requires that departures from Board Opinions be disclosed in footnotes to the financial statements or in independent auditors' reports when the effect of the departure on the financial statements is material.

Unless otherwise stated, Opinions of the Board are not intended to be retroactive. They are not intended to be applicable to immaterial items.

APB Opinion No. 15

EARNINGS PER SHARE

MAY, 1969

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INTRODUCTION

1. Earnings per share data are used in evaluating the past operating performance of a business, in forming an opinion as to its potential and in making investment decisions. They are commonly presented in prospectuses, proxy material and reports to stockholders. They are used in the compilation of business earnings data for the press, statistical services and other publications. When presented with formal financial statements, they assist the investor in weighing the significance of a corporation's current net income and of changes in its net income from period to period in relation to the shares he holds or may acquire.

2. In view of the widespread use of earnings per share data, it is important that such data be computed on a consistent basis and presented in the most meaningful manner. The Board and its predecessor committee have previously expressed their views on general standards designed to achieve these objectives, most recently in Part II of APB Opinion No. 9, *Reporting the Results of Operations.*

3. In this Opinion the Board expresses its views on some of the more specific aspects of the subject, including the guidelines that should be applied uniformly in the computation and presentation of earnings per share data in financial statements. Accordingly, this Opinion supersedes Part II (paragraphs 30-51) and Exhibit E of APB Opinion No. 9. In some respects, practice under APB Opinion No. 9 will be changed by this Opinion.

4. Computational guidelines for the implementation of this Opinion are contained in Appendix A. Certain views differing from those adopted in this Opinion are summarized in Appendix B. Illustrations of the presentations described in this Opinion are included in the Exhibits contained in Appendix C. Definitions of certain terms as used in this Opinion are contained in Appendix D.

APPLICABILITY

5. This Opinion applies to financial presentations which purport to present results of operations of corporations in conformity with generally accepted accounting principles and to summaries of those presentations, except as excluded in paragraph 6. Thus, it applies to corporations whose capital structures include only common stock or common stock and senior securities and to those whose capital structures also include securities that should be considered the equivalent of common stock[1] in computing earnings per share data.

6. This Opinion does not apply to mutual companies that do not have outstanding common stock or common stock equivalents (for example, mutual savings banks, cooperatives, credit unions, and similar entities); to registered investment companies; to government-owned corporations; or to nonprofit corporations. This Opinion also does not apply to parent company statements accompanied by consolidated financial statements, to statements of wholly-owned subsidiaries, or to special purpose statements.

HISTORICAL BACKGROUND

7. Prior to the issuance of APB Opinion No. 9, earnings per share were generally computed by dividing net income (after deducting preferred stock dividends, if any) by the number of common shares outstanding. The divisor used in the computation usually was a weighted average of the number of common shares outstanding during the period, but sometimes was simply the number of common shares outstanding at the end of the period.

8. ARB No. 49, *Earnings per Share,* referred to "common stock or other residual security;" however, the concept that a security other than a common stock could be the substantial equivalent of common stock and should, therefore, enter into the computation of earnings per share was seldom followed prior to the issuance of APB Opinion No. 9. Paragraph 33 of APB Opinion No. 9 stated that earnings per share should be computed by reference

[1] APB Opinion No. 9 referred to certain securities as *residual* securities, the determination of which was generally based upon the market value of the security as it related to investment value. In this Opinion, the Board now uses the term *common stock equivalents* as being more descriptive of those securities other than common stock that should be dealt with as common stock in the determination of earnings per share.

to common stock and other residual securities and defined a residual security as follows:

"When more than one class of common stock is outstanding, or when an outstanding security has participating dividend rights with the common stock, or when an outstanding security clearly derives a major portion of its value from its conversion rights or its common stock characteristics, such securities should be considered 'residual securities' and not 'senior securities' for purposes of computing earnings per share."

9. APB Opinion No. 9 also stated in part (paragraph 43) that:

"Under certain circumstances, earnings per share may be subject to dilution in the future if existing contingencies permitting issuance of common shares eventuate. Such circumstances include contingent changes resulting from the existence of (a) outstanding senior stock or debt which is convertible into common shares, (b) outstanding stock options, warrants or similar agreements and (c) agreements for the issuance of common shares for little or no consideration upon the satisfaction of certain conditions (e.g., the attainment of specified levels of earnings following a business combination). If such potential dilution is material, supplementary pro forma computations of earnings per share should be furnished, showing what the earnings would be if the conversions or contingent issuances took place."

Before the issuance of APB Opinion No. 9 corporations had rarely presented pro forma earnings per share data of this type except in prospectuses and proxy statements.

10. Under the definition of a residual security contained in paragraph 33 of APB Opinion No. 9, residual status of convertible securities has been determined using the "major-portion-of-value" test at the time of the issuance of the security and from time to time thereafter whenever earnings per share data were presented. In practice this test has been applied by comparing a convertible security's market value with its investment value, and the security has been considered to be residual whenever more than half its market value was attributable to its common stock characteristics at time of issuance. Practice has varied in applying this test subsequent to issuance with a higher measure used in many cases. Thus, a convertible security's status as a residual security has been affected by equity and debt market conditions at and after the security's issuance.

11. Application of the residual security concept as set forth in paragraph 33 of APB Opinion No. 9 has raised questions as to the validity of the concept and as to the guidelines developed for its application in practice. The Board has reviewed the concept of residual securities as it relates to earnings per share and, as a result of its own study and the constructive comments on the matter received from interested parties, has concluded that modification of the residual concept is desirable. The Board has also considered the disclosure and presentation requirements of earnings per share data contained in APB Opinion No. 9 and has concluded that these should be revised.

OPINION

Presentation on Face of Income Statement

12. The Board believes that the significance attached by investors and others to earnings per share data, together with the importance of evaluating the data in conjunction with the financial statements, requires that such data be presented prominently in the financial statements. The Board has therefore concluded that earnings per share or net loss per share data should be shown on the face of the income statement. The extent of the data to be presented and the captions used will vary with the complexity of the company's capital structure, as discussed in the following paragraphs.

13. The reporting of earnings per share data should be consistent with the income statement presentation called for by paragraph 20 of APB Opinion No. 9. Earnings per share amounts should therefore be presented for (a) income before extraordinary items and (b) net income. It may also be desirable to present earnings per share amounts for extraordinary items, if any.

Simple Capital Structures

14. The capital structures of many corporations are relatively simple—that is, they either consist of only common stock or include no potentially dilutive convertible securities, options, warrants or other rights that upon conversion or exercise

could in the aggregate dilute[3] earnings per common share. In these cases, a single presentation expressed in terms such as *Earnings per common share* on the face of the income statement (based on common shares outstanding and computed in accordance with the provisions of paragraphs 47-50 of Appendix A) is the appropriate presentation of earnings per share data.

Complex Capital Structures

15. Corporations with capital structures other than those described in the preceding paragraph should present two types of earnings per share data (dual presentation) with equal prominence on the face of the income statement. The first presentation is based on the outstanding common shares and those securities that are in substance equivalent to common shares and have a dilutive[3] effect. The second is a pro-forma presentation which reflects the dilution[3] of earnings per share that would have occurred if *all* contingent issuances of common stock that would individually reduce earnings per share had taken place at the beginning of the period (or time of issuance of the convertible security, etc., if later). For convenience in this Opinion, these two presentations are referred to as "primary earnings per share" and "fully diluted earnings per share,"[4] respectively, and would in certain circumstances discussed elsewhere in this Opinion be supplemented by other disclosures and other earnings per share data. (See paragraphs 19-23.)

Dual Presentation

16. When dual presentation of earnings per share data is required, the primary and fully diluted earnings per share amounts should be presented with equal prominence on the face of the income statement. The difference between the primary and fully diluted earnings per share amounts shows the maximum extent of potential dilution of current earnings which conversions of securities that are not common stock equivalents could create. If the capital structure contains no common stock equivalents, the first may be designated *Earnings per common share—assuming no dilution* and the second *Earnings per common share—assuming full dilution.* When common stock equivalents are present and dilutive, the primary amount may be designated *Earnings per common and common equivalent share.* The Board recognizes that precise designations should not be prescribed; corporations should be free to designate these dual presentations in a manner which best fits the circumstances provided they are in accord with the substance of this Opinion. The term *Earnings per common share* should not be used without appropriate qualification except under the conditions discussed in paragraph 14.

Periods Presented

17. Earnings per share data should be presented for all periods covered by the statement of income or summary of earnings. If potential dilution exists in any of the periods presented, the dual presentation of primary earnings per share and fully diluted earnings per share data should be made for all periods presented. This information together with other disclosures required (see paragraphs 19-23) will give the reader an understanding of the extent and trend of the potential dilution.

18. When results of operations of a prior period included in the statement of income or summary of earnings have been restated as a result of a prior period adjustment, earnings per share data given for the prior period should be restated. The effect of the restatement, expressed in per share terms, should be disclosed in the year of restatement.

Additional Disclosures

Capital Structure

19. The use of complex securities complicates earnings per share computations and makes additional disclosures necessary. The Board has concluded that financial statements should include a description, in summary form, sufficient to explain the pertinent rights and privileges of the various securities outstanding. Examples of information which should be disclosed are dividend and liquidation preferences, participation rights, call prices and dates, conversion or exercise prices or rates and pertinent dates, sinking fund requirements, unusual voting rights, etc.

[3] Any reduction of less than 3% in the aggregate need not be considered as dilution in the computation and presentation of earnings per share data as discussed throughout this Opinion. In applying this test only issues which reduce earnings per share should be considered. In establishing this guideline the Board does not imply that a similar measure should be applied in any circumstances other than the computation and presentation of earnings per share data under this Opinion.

[4] APB Opinion No. 9 referred to the latter presentation as "supplementary pro forma earnings per share."

Dual Earnings per Share Data

20. A schedule or note relating to the earnings per share data should explain the bases upon which both primary and fully diluted earnings per share are calculated. This information should include identification of any issues regarded as common stock equivalents in the computation of primary earnings per share and the securities included in the computation of fully diluted earnings per share. It should describe all assumptions and any resulting adjustments used in deriving the earnings per share data.[4] There should also be disclosed the number of shares issued upon conversion, exercise or satisfaction of required conditions, etc., during at least the most recent annual fiscal period and any subsequent interim period presented.[5]

21. Computations and/or reconciliations may sometimes be desirable to provide a clear understanding of the manner in which the earnings per share amounts were obtained. This information may include data on each issue of securities entering into the computation of the primary and fully diluted earnings per share. It should not, however, be shown on the face of the income statement or otherwise furnished in a manner implying that an earnings per share amount which ignores the effect of common stock equivalents (that is, earnings per share based on outstanding common shares only) constitutes an acceptable presentation of primary earnings per share.

Supplementary Earnings per Share Data

22. Primary earnings per share should be related to the capital structures existing during each of the various periods presented.[6] Although conversions ordinarily do not alter substantially the amount of capital employed in the business, they can significantly affect the trend in earnings per share data. Therefore, if conversions during the current period would have affected (either dilutively or incrementally) primary earnings per share if they had taken place at the beginning of the period, supplementary information should be furnished (preferably in a note) for the latest period showing what primary earnings per share would have been if such conversions had taken place at the beginning of that period (or date of issuance of the security, if within the period). Similar supplementary per share earnings should be furnished if conversions occur after the close of the period but before completion of the financial report. It may also be desirable to furnish supplementary per share data for each period presented, giving the cumulative retroactive effect of all such conversions or changes. However, primary earnings per share data should not be adjusted retroactively for conversions.

23. Occasionally a sale of common stock or common stock equivalents for cash occurs during the latest period presented or shortly after its close but before completion of the financial report. When a portion or all of the proceeds of such a sale has been used to retire preferred stock or debt, or is to be used for that purpose, supplementary earnings per share data should be furnished (preferably in a note) to show what the earnings would have been for the latest fiscal year and any subsequent interim period presented if the retirement had taken place at the beginning of the respective period (or date of issuance of the retired security, if later). The number of shares of common stock whose proceeds are to be used to retire the preferred stock or debt should be included in this computation. The bases of these supplementary computations should be disclosed.[7]

Primary Earnings per Share

24. If a corporation's capital structure is complex and either does not include common stock equivalents or includes common stock equivalents which do not have a dilutive effect, the primary earnings per share figures should be based on the weighted average number of shares of common stock outstanding during the period. In such cases, potential dilutive effects of contingent issuances would be reflected in the fully diluted earnings per share amounts. Certain securities, however, are considered to be the equivalent of outstanding common stock and should be recognized in the computation of primary earnings per share if they have a dilutive effect.

Nature of Common Stock Equivalents

25. The concept that a security may be the equivalent of common stock has evolved

[4] These computations should give effect to all adjustments which would result from conversion: for example, dividends paid on convertible preferred stocks should not be deducted from net income; interest and related expenses on convertible debt, less applicable income tax, should be added to net income, and any other adjustments affecting net income because of these assumptions should also be made. (See paragraph 51.)

[5] See also paragraphs 9 and 10 of APB Opinion No. 12.

[6] See paragraphs 48-49 and 62-64 for exceptions to this general rule.

[7] There may be other forms of recapitalization which should be reflected in a similar manner.

to meet the reporting needs of investors in corporations that have issued certain types of convertible and other complex securities. A common stock equivalent is a security which is not, in form, a common stock but which usually contains provisions to enable its holder to become a common stockholder and which, because of its terms and the circumstances under which it was issued, is in substance equivalent to a common stock. The holders of these securities can expect to participate in the appreciation of the value of the common stock resulting principally from the earnings and earnings potential of the issuing corporation. This participation is essentially the same as that of a common stockholder except that the security may carry a specified dividend or interest rate yielding a return different from that received by a common stockholder. The attractiveness of this type of security to investors is often based principally on this potential right to share in increases in the earnings potential of the issuing corporation rather than on its fixed return or other senior security characteristics. With respect to a convertible security, any difference in yield between it and the underlying common stock as well as any other senior characteristics of the convertible security become secondary. The value of a common stock equivalent is derived in large part from the value of the common stock to which it is related, and changes in its value tend to reflect changes in the value of the common stock. Neither conversion nor the imminence of conversion is necessary to cause a security to be a common stock equivalent.

26. The Board has concluded that outstanding convertible securities which have the foregoing characteristics and which meet the criteria set forth in this Opinion for the determination of common stock equivalents at the time they are issued should be considered the equivalent of common stock in computing primary earnings per share if the effect is dilutive. The recognition of common stock equivalents in the computation of primary earnings per share avoids the misleading implication which would otherwise result from the use of common stock only; use of the latter basis would place form over substance.

27. In addition to convertible debt and convertible preferred stocks, the following types of securities are or may be considered as common stock equivalents:

Stock options and warrants (and their equivalents) and stock purchase contracts—should always be considered common stock equivalents (see paragraphs 35-38).

Participating securities and two-class common stocks—if their participation features enable their holders to share in the earnings potential of the issuing corporation on substantially the same basis as common stock even though the securities may not give the holder the right to exchange his shares for common stock (see paragraphs 59 and 60).

Contingent shares—if shares are to be issued in the future upon the mere passage of time (or are held in escrow pending the satisfaction of conditions unrelated to earnings or market value) they should be considered as outstanding for the computation of earnings per share. If additional shares of stock are issuable for little or no consideration upon the satisfaction of certain conditions they should be considered as outstanding when the conditions are met (see paragraphs 61-64).

Determination of Common Stock Equivalents at Issuance

28. The Board has concluded that determination of whether a convertible security is a common stock equivalent should be made only at the time of issuance and should not be changed thereafter so long as the security remains outstanding. However, convertible securities outstanding or subsequently issued with the same terms as those of a common stock equivalent also should be classified as common stock equivalents. After full consideration of whether a convertible security may change its status as a common stock equivalent subsequent to issuance, including the differing views which are set forth in Appendix B hereto, the Board has concluded that the dilutive effect of any convertible securities that were not common stock equivalents at time of their issuance should be included only in the fully diluted earnings per share amount. This conclusion is based upon the belief (a) that only the conditions which existed at the time of issuance of the convertible security should govern the determination of status as a common stock equivalent, and (b) that the presentation of fully diluted earnings per share data adequately discloses the potential dilution which may exist because of changes in conditions subsequent to time of issuance.

29. Various factors should be considered in determining the appropriate "time of issuance" in evaluating whether a

security is substantially equivalent to a common stock. The time of issuance generally is the date when agreement as to terms has been reached and announced, even though subject to certain further actions, such as directors' or stockholders' approval.

No Anti-Dilution

30. Computations of primary earnings per share should not give effect to common stock equivalents or other contingent issuance for any period in which their inclusion would have the effect of increasing the earnings per share amount or decreasing the loss per share amount otherwise computed.[8] Consequently, while a security once determined to be a common stock equivalent retains that status, it may enter into the computation of primary earnings per share in one period and not in another.

Test of Common Stock Equivalent Status

31. *Convertible securities.* A convertible security which at the time of issuance has terms that make it for all practical purposes substantially equivalent to a common stock should be regarded as a common stock equivalent. The complexity of convertible securities makes it impractical to establish definitive guidelines to encompass all the varying terms which might bear on this determination. Consideration has been given, however, to various characteristics of a convertible security which might affect its status as a common stock equivalent, such as cash yield at issuance, increasing or decreasing conversion rates, liquidation and redemption amounts, and the conversion price in relation to the market price of the common stock. In addition, consideration has been given to the pattern of various nonconvertible security yields in recent years, during which period most of the existing convertible securities have been issued, as well as over a longer period of time. Many of the characteristics noted above, which in various degrees may indicate status as a common stock equivalent, are also closely related to the interest or dividend rate of the security and to its market price at the time of issuance.

32. The Board has also studied the use of market price in relation to investment value (value of a convertible security without the conversion option) and market parity (relationship of conversion value of a convertible security to its market price) as means of determining if a convertible security is equivalent to a common stock. (See discussion of investment value and market parity tests in Appendix B.) It has concluded, however, that these tests are too subjective or not sufficiently practicable.

33. The Board believes that convertible securities should be considered common stock equivalents if the cash yield to the holder at time of issuance is significantly below what would be a comparable rate for a similar security of the issuer without the conversion option. Recognizing that it may frequently be difficult or impossible to ascertain such comparable rates, and in the interest of simplicity and objectivity, the Board has concluded that a convertible security should be considered as a common stock equivalent at the time of issuance if, based on its market price,[9] it has a cash yield of less than 66⅔% of the then current bank prime interest rate.[10] For any convertible security which has a change in its cash interest rate or cash dividend rate scheduled within the first five years after issuance, the lowest scheduled rate during such five years should be used in determining the cash yield of the security at issuance.

34. The Board believes that the current bank prime interest rate in general use for short-term loans represents a practical, simple and readily available basis on which to establish the criteria for determining a common stock equivalent, as set forth in the preceding paragraph. The Board recognizes that there are other rates and averages of interest rates relating to various grades of long-term debt securities and preferred stocks which might be appropriate or that a more complex approach could be adopted. However, after giving consideration to various approaches and interest rates in this regard, the Board has concluded that since there is a high degree of correlation between such indices and the bank prime interest rate, the latter is the

[8] The presence of a common stock equivalent together with extraordinary items may result in diluting income before extraordinary items on a per share basis while increasing net income per share, or vice versa. If an extraordinary item is present and a common stock equivalent results in dilution of either income before extraordinary items or net income on a per share basis, the common stock equivalent should be recognized for all computations even though it has an anti-dilutive effect on one of the per share amounts.

[9] If no market price is available, this test should be based on the fair value of the security.

[10] If convertible securities are sold or issued outside the United States, the most comparable interest rate in the foreign country should be used for this test.

most practical rate available for this particular purpose.

35. *Options and warrants (and their equivalents).* Options, warrants and similar arrangements usually have no cash yield and derive their value from their right to obtain common stock at specified prices for an extended period. Therefore, these securities should be regarded as common stock equivalents at all times. Other securities, usually having a low cash yield (see definition of "cash yield", Appendix D), require the payment of cash upon conversion and should be considered the equivalents of warrants for the purposes of this Opinion. Accordingly, they should also be regarded as common stock equivalents at all times. Primary earnings per share should reflect the dilution that would result from exercise or conversion of these securities and use of the funds, if any, obtained. Options and warrants (and their equivalents) should, therefore, be treated as if they had been exercised and earnings per share data should be computed as described in the following paragraphs. The computation of earnings per share should not, however, reflect exercise or conversion of any such security[11] if its effect on earnings per share is anti-dilutive (see paragraph 30) except as indicated in paragraph 38.

36. Except as indicated in this paragraph and in paragraphs 37 and 38, the amount of dilution to be reflected in earnings per share data should be computed by application of the "treasury stock" method. Under this method, earnings per share data are computed as if the options and warrants were exercised at the beginning of the period (or at time of issuance, if later) and as if the funds obtained thereby were used to purchase common stock at the average market price during the period.[12] As a practical matter, the Board recommends that assumption of exercise not be reflected in earnings per share data until the market price of the common stock obtainable has been in excess of the exercise price for substantially all of three consecutive months ending with the last month of the period to which earnings per share data relate. Under the treasury stock method, options and warrants have a dilutive effect (and are, therefore, reflected in earnings per share computations) only when the average market price of the common stock obtainable upon exercise during the period exceeds the exercise price of the options or warrants. Previously reported earnings per share amounts should not be retroactively adjusted, in the case of options and warrants, as a result of changes in market prices of common stock. The Board recognizes that the funds obtained by issuers from the exercise of options and warrants are used in many ways with a wide variety of results that cannot be anticipated. Application of the treasury stock method in earnings per share computations is not based on an assumption that the funds will or could actually be used in that manner. In the usual case, it represents a practical approach to reflecting the dilutive effect that would result from the issuance of common stock under option and warrant agreements at an effective price below the current market price. The Board has concluded, however, that the treasury stock method is inappropriate, or should be modified, in certain cases described in paragraphs 37 and 38.

37. Some warrants contain provisions which permit, or require, the tendering of debt (usually at face amount) or other securities of the issuer in payment for all or a portion of the exercise price. The terms of some debt securities issued with warrants require that the proceeds of the exercise of the related warrants be applied toward retirement of the debt. As indicated in paragraph 35, some convertible securities require cash payments upon conversion and are, therefore, considered to be the equivalent of warrants. In all of these cases, the "if converted" method (see paragraph 51) should be applied as if retirement or conversion of the securities had occurred and as if the excess proceeds, if any, had been applied to the purchase of common stock under the treasury stock method. However, exercise of the options and warrants should not be reflected in the computation unless for the period specified in paragraph 36 either (a) the market price of the related common stock exceeds the exercise price or (b) the security which may be (or must be) tendered is selling at a price below that at which it may be tendered under the option or warrant agreement and the resulting discount is sufficient to establish an effective exercise price below the market price of the common stock that can be obtained upon exercise. Similar

[11] Reasonable grouping of like securities may be appropriate.

[12] For example, if a corporation has 10,000 warrants outstanding, exercisable at $54 and the average market price of the common stock during the reporting period is $60, the $540,000 which would be realized from exercise of the warrants and issuance of 10,000 shares would be an amount sufficient to acquire 9,000 shares; thus 1,000 shares would be added to the outstanding common shares in computing primary earnings per share for the period.

treatment should be followed for preferred stock bearing similar provisions or other securities having conversion options permitting payment of cash for a more favorable conversion rate from the standpoint of the investor.

38. The treasury stock method of reflecting use of proceeds from options and warrants may not adequately reflect potential dilution when options or warrants to acquire a substantial number of common shares are outstanding. Accordingly, the Board has concluded that, if the number of shares of common stock obtainable upon exercise of outstanding options and warrants in the aggregate exceeds 20% of the number of common shares outstanding at the end of the period for which the computation is being made, the treasury stock method should be modified in determining the dilutive effect of the options and warrants upon earnings per share data. In these circumstances all the options and warrants should be assumed to have been exercised and the aggregate proceeds therefrom to have been applied in two steps:

a. As if the funds obtained were first applied to the repurchase of outstanding common shares at the average market price during the period (treasury stock method) but not to exceed 20% of the outstanding shares; and then

b. As if the balance of the funds were applied first to reduce any short-term or long-term borrowings and any remaining funds were invested in U. S. government securities or commercial paper, with appropriate recognition of any income tax effect.

The results of steps (a) and (b) of the computation (whether dilutive or anti-dilutive) should be aggregated and, if the net effect is dilutive, should enter into the earnings per share computation.[13]

Non-Recognition of Common Stock Equivalents in Financial Statements

39. The designation of securities as common stock equivalents in this Opinion is solely for the purpose of determining primary earnings per share. No changes from present practices are recommended in the accounting for such securities, in their presentation within the financial statements or in the manner of determining net assets per common share. Information is available in the financial statements and elsewhere for readers to make judgments as to the present and potential status of the various securities outstanding.

Fully Diluted Earnings per Share

No Anti-Dilution

40. The purpose of the fully diluted earnings per share presentation is to show the

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[13] The following are examples of the application of Paragraph 38:

	Case 1	Case 2
Assumptions:		
Net income for year	$ 4,000,000	$ 2,000,000
Common shares outstanding	3,000,000	3,000,000
Options and warrants outstanding to purchase equivalent shares	1,000,000	1,000,000
20% limitation on assumed repurchase	600,000	600,000
Exercise price per share	$15	$15
Average and year-end market value per common share to be used (see paragraph 42)	$20	$12
Computations:		
Application of assumed proceeds ($15,000,000):		
Toward repurchase of outstanding common shares at applicable market value	$12,000,000	$ 7,200,000
Reduction of debt	3,000,000	7,800,000
	$15,000,000	$15,000,000
Adjustment of net income:		
Actual net income	$ 4,000,000	$ 2,000,000
Interest reduction (6%) less 50% tax effect	90,000	234,000
Adjusted net income (A)	$ 4,090,000	$ 2,234,000
Adjustment of shares outstanding:		
Actual outstanding	3,000,000	3,000,000
Net additional shares issuable (1,000,000—600,000)	400,000	400,000
Adjusted shares outstanding (B)	3,400,000	3,400,000
Earnings per share:		
Before adjustment	$1.33	$ .67
After adjustment (A ÷ B)	$1.20	$ .66

maximum potential dilution of current earnings per share on a prospective basis. Consequently, computations of fully diluted earnings per share for each period should exclude those securities whose conversion, exercise or other contingent issuance would have the effect of increasing the earnings per share amount or decreasing the loss per share amount[14] for such period.

When Required

41. Fully diluted earnings per share data should be presented on the face of the statement of income for each period presented if shares of common stock (a) were issued during the period on conversions, exercise, etc., or (b) were contingently issuable at the close of any period presented and if primary earnings per share for such period would have been affected (either dilutively or incrementally) had such actual issuances taken place at the beginning of the period or would have been reduced had such contingent issuances taken place at the beginning of the period. The above contingencies may result from the existence of (a) senior stock or debt which is convertible into common shares but is not a common stock equivalent, (b) options or warrants, or (c) agreements for the issuance of common shares upon the satisfaction of certain conditions (for example, the attainment of specified higher levels of earnings following a business combination). The computation should be based on the assumption that all such issued and issuable shares were outstanding from the beginning of the period (or from the time the contingency arose, if after the beginning of the period). Previously reported fully diluted earnings per share amounts should not be retroactively adjusted for subsequent conversions or subsequent changes in the market prices of the common stock.

42. The methods described in paragraphs 36-38 should be used to compute fully diluted earnings per share if dilution results from outstanding options and warrants; however, in order to reflect maximum potential dilution, the market price at the close of the period reported upon should be used to determine the number of shares which would be assumed to be repurchased (under the treasury stock method) if such market price is higher than the average price used in computing primary earnings per share (see paragraph 30). Common shares issued on exercise of options or warrants during each period should be included in fully diluted earnings per share from the beginning of the period or date of issuance of the options or warrants if later; the computation for the portion of the period prior to the date of exercise should be based on market prices of the common stock when exercised.

Situations Not Covered in Opinion

43. The Board recognizes that it is impracticable to cover all possible conditions and circumstances that may be encountered in computing earnings per share. When situations not expressly covered in this Opinion occur, however, they should be dealt with in accordance with their substance, giving cognizance to the guidelines and criteria outlined herein.

Computational Guidelines

44. The determination of earnings per share data required under this Opinion reflects the complexities of the capital structures of some businesses. The calculations should give effect to matters such as stock dividends and splits, business combinations, changes in conversion rates, etc. Guidelines which should be used in dealing with some of the more common computational matters are set forth in Appendix A hereto.

EFFECTIVE DATE

45. This Opinion shall be effective for fiscal periods beginning after December 31, 1968 for all earnings per share data (primary, fully diluted and supplementary) regardless of when the securities entering into computations of earnings per share were issued, except as described in paragraph 46 as it relates to primary earnings per share. The Board recommends that (a) computations for periods beginning before January 1, 1969 be made for all securities in conformity with the provisions of this Opinion and (b) in comparative statements in which the data for some periods are subject to this Opinion and others are not, the provisions of the Opinion be applied to all periods—in either case based on the conditions existing in the prior periods.

46. In the case of securities whose time of issuance is prior to June 1, 1969 the following election should be made as of May 31, 1969 (and not subsequently changed)

[14] See footnote 8.

with respect to all such securities for the purpose of computing primary earnings per share:

a. determine the classifications of all such securities under the provisions of this Opinion, or

b. classify as common stock equivalents only those securities which are classified as residual securities under APB Opinion No. 9 regardless of how they would be classified under this Opinion.

If the former election is made, the provisions of this Opinion should be applied in the computation of both primary and fully diluted earnings per share data for all periods presented.

The Opinion entitled "Earnings per Share" was adopted by the assenting votes of fifteen members of the Board, of whom five, Messrs. Axelson, Davidson, Harrington, Hellerson and Watt, assented with qualification. Messrs. Halvorson, Seidman and Weston dissented.

Messrs. Axelson and Watt dissent to the requirement in paragraphs 35 and 36 that options and warrants whose exercise price is at or above the market price of related common stock at time of issuance be taken into account in the computation of *primary* earnings per share. They believe that this destroys the usefulness of the dual presentation of primary and fully diluted earnings per share by failing to disclose the magnitude of the contingency arising from the outstanding warrants and options and is inconsistent with the determination of the status of convertible securities at time of issuance only. Therefore, they concur with the comments in paragraph 86. They also dissent to the 20 percent limitation in paragraph 38 on use of the treasury stock method of applying proceeds from the assumed exercise of options and warrants because such limitation is arbitrary and unsupported and because of the inconsistency between this limitation and the Board's conclusion expressed in paragraph 36 that use of the treasury stock method "is not based on an assumption that the funds will or could actually be used in that manner." Further, they dissent to the requirement in paragraphs 63 and 64 that the computation of *primary* earnings per share take into account shares of stock issuable in connection with business combinations on a purely contingent basis, wholly dependent upon the movement of market prices in the future.

Mr. Davidson assents to the issuance of this Opinion because he believes that practice under Part II of APB Opinion No. 9 has been so varied that clarification of APB Opinion No. 9 is necessary. He agrees with the concept of common stock equivalents, but dissents to the conclusion that convertible securities can be classified as common stock equivalents only by consideration of conditions prevailing at the time of their issuance (paragraph 28). He believes that in determining common stock equivalency, current conditions reflected in the market place are the significant criterion (paragraphs 74-77). The use of the investment value method (paragraphs 79-81) adequately reflects these current conditions.

Mr. Davidson also dissents to the use of the bank prime rate for the cash-yield test (paragraphs 33-34). It does not differentiate among types of securities issued nor the standing of the issuers.

Mr. Harrington assents to the issuance of the Opinion; however, he dissents from paragraphs 36, 37 and 38. He believes it is inconsistent in computing fully diluted earnings per share to measure potential dilution by the treasury stock method in the case of most warrants and to assume conversion in the case of convertible securities. This inconsistency, in his view, results in required recognition of potential dilution attributable to all convertible securities; and, at the same time through the use of the treasury stock method, permits understatement or no recognition of potential dilution attributable to warrants. He further believes that the potential dilution inherent in warrants should be recognized in fully diluted earnings per share, but need not be recognized in primary earnings per share, when the exercise price exceeds the market price of the stock.

Mr. Hellerson assents to the issuance of this Opinion because he believes the Board has an obligation to resolve without further delay the implementation problems raised by Part II of APB Opinion No. 9 which have been greatly extended by the characteristics of a number of the securities issued since the release of that Opinion. However, he dissents from the mandatory requirement that earnings per share be shown on the face of the income statement as prescribed in paragraphs 12 through 16 and paragraph 41. The accounting profession has taken the position, and in his view rightly so, that fair presentation of financial position and results of operations requires the presentation of certain basic financial statements supplemented by disclosure of additional information in the form of separate statements or notes to the basic financial statements. Fair presentation is achieved by the whole presentation, not by the specific location of any item. This principle was most recently restated by the Board in paragraph 10 of APB Opinion No. 12 on capital changes as follows: "Disclosure of such changes may take the form of separate statements or may be made in the basic financial statements or notes thereto." Accordingly, it is his view that, although the Opinion should require dual presentation of earnings per share, it should not specify that the presentation must be made on the face of the income statement and thereby dignify one figure above all others.

Mr. Halvorson dissents to the Opinion because he believes the subject matter is one of financial analysis, not accounting principles, and that any expression by the Accounting Principles Board on the subject should not go beyond requiring such disclosure of the respective rights and priorities of the several issues of securities which may be represented in the capital structure of a reporting corporation as will permit an investor to make his own analysis of the effects of such rights and priorities on earnings per common share. Mr. Halvorson agrees that certain nominally senior securities are the equivalent of common shares under certain circumstances, but believes that the determination of common-stock equivalence is a subjective one which cannot be accommodated within prescribed formulae or arithmetical rules, although it can be facilitated by disclosure of information which does fall within the bounds of fair presentation in conformity with generally accepted accounting principles. Mr. Halvorson believes that a corporation should not be denied the right to report factually determined earnings per weighted average outstanding common share on the face of the income statement as a basis against which to measure the potential dilutive effects on earnings per share of senior issues, and that from such basis the investor may make such pro forma calculations of common-stock equivalence as he believes best serve his purpose.

Mr. Seidman dissents for the reasons set forth in paragraphs 72, 73, 92 and 93, dealing with the invalidity and inconsistent application of the concept of common stock equivalents. He adds: (1) It is unsound for the determination of earnings per share to depend on the fluctuations of security prices. It is even more unsound when an increase in security prices can result in a decrease in earnings per share, and vice versa. These matters arise under this Opinion since it calls for earnings per share based on cash yield of convertibles, comparison of stock and exercise prices of options and warrants, and no anti-dilution. (2) It is erroneous to attribute earnings to securities that do not currently and may never share in those earnings, particularly when part or all of those earnings may have already been distributed to others as dividends. (3) It does not serve the interests of meaningful disclosure when, as in paragraph 21, the Opinion bans showing on the face of the income statement any reference to the amount of earnings per share in relation to the one factual base, namely the number of shares actually outstanding, and instead fashions from various surmises what it calls "primary earnings per share". (4) It is baffling to say, as does this Opinion, that convertible debt is debt in the statement of earnings but is common stock equivalent in the statement of earnings per share; and that dividends per share are based on the actual number of shares outstanding, while earnings per share are based on a different and larger number of shares.

Mr. Weston dissents to the issuance of this Opinion because he believes it represents a significant retrogression in terms of the purpose of the Accounting Principles Board. The residual security concept, which has been successfully and appropriately applied to convertible securities during the period since issuance of APB Opinion No. 9, has, in this Opinion, been so restricted as to be meaningless for all practical purposes with respect to such securities. Accordingly, computations of primary earnings per share data under the provisions of this Opinion (paragraph 28 in particular) will not properly reflect the characteristics of those convertible securities which are currently the substantial equivalent of common stock—and are so recognized in the marketplace—which did not qualify for residual status at their date of issuance—possibly years previously. Such disregard of basic principles is a disservice to investors, who have a right to view the primary earnings per share data computed under this Opinion as a realistic attribution of the earnings of the issuer to the various complex elements of its capital structure based on the economic realities of today—not those existing years ago.

Mr. Weston also disagrees with the conclusions contained in paragraphs 33, 36, 39 and 51.

NOTES

Opinions present the considered opinion of at least two-thirds of the members of the Accounting Principles Board, reached on a formal vote after examination of the subject matter.

Except as indicated in the succeeding paragraph, the authority of the Opinions rests upon their general acceptability. While it is recognized that general rules may be subject to exception, the burden of justifying departures from Board Opinions must be assumed by those who adopt other practices.

Action of Council of the Institute (Special Bulletin, Disclosure of Departures from Opinions of the Accounting Principles Board, *October, 1964) provides that:*

a. "Generally accepted accounting principles" are those principles which have substantial authoritative support.

b. Opinions of the Accounting Principles Board constitute "substantial authoritative support."

c. "Substantial authoritative support" can exist for accounting principles that differ from Opinions of the Accounting Principles Board.

The Council action also requires that departures from Board Opinions be disclosed in footnotes to the financial statements or in independent auditors' reports when the effect of the departure on the financial statements is material.

Unless otherwise stated, Opinions of the Board are not intended to be retroactive. They are not intended to be applicable to immaterial items.

Accounting Principles Board (1969)

LEROY LAYTON, *Chairman*	JOSEPH P. CUMMINGS	CHARLES T. HORNGREN
MARSHALL S. ARMSTRONG	SIDNEY DAVIDSON	LOUIS M. KESSLER
KENNETH S. AXELSON	PHILIP L. DEFLIESE	ORAL L. LUPER
DONALD J. BEVIS	NEWMAN T. HALVORSON	J. S. SEIDMAN
MILTON M. BROEKER	EMMETT S. HARRINGTON	GEORGE C. WATT
GEORGE R. CATLETT	CHARLES B. HELLERSON	FRANK T. WESTON

APPENDIX A

COMPUTATIONAL GUIDELINES

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The Board has adopted the following general guidelines which should be used in the computation of earnings per share data.

47. *Weighted average.* Computations of earnings per share data should be based on the weighted average number of common shares and common share equivalents outstanding during each period presented. Use of a weighted average is necessary so that the effect of increases or decreases in outstanding shares on earnings per share data is related to the portion of the period during which the related consideration affected operations. Reacquired shares should be excluded from date of their acquisition. (See definition in Appendix D.)

48. *Stock dividends or splits.* If the number of common shares outstanding increases as a result of a stock dividend or stock split [15] or decreases as a result of a reverse split, the computations should give retroactive recognition to an appropriate equivalent change in capital structure for all periods presented. If changes in common stock resulting from stock dividends or stock splits or reverse splits have been consummated after the close of the period but before completion of the financial report, the per share computations should be based on the new number of shares because the readers' primary interest is presumed to be related to the current capitalization. When per share computations reflect such changes in the number of shares after the close of the period, this fact should be disclosed.

49. *Business combinations and reorganizations.* When shares are issued to acquire a business in a transaction accounted for as a purchase, the computation of earnings per share should give recognition to the existence of the new shares only from the date the acquisition took place. When a business combination is accounted for as a pooling of interests, the computation should be based on the aggregate of the weighted average outstanding shares of the constituent businesses, adjusted to equivalent shares of the surviving business for all periods presented. This difference in treatment reflects the fact that in a purchase the results of operations of the acquired business are included in the statement of income only from the date of acquisition, whereas in a pooling of interests the results of operations are combined for all periods presented. In reorganizations, the computations should be based on analysis of the particular transaction according to the criteria contained in this Opinion.

50. *Claims of senior securities.* The claims of senior securities on earnings of a period should be deducted from net income (and also from income before extraordinary items if an amount therefor appears in the statement) before computing earnings per share. Dividends on cumulative preferred senior securities, whether or not earned, should be deducted from net income.[16] If there is a net loss, the amount of the loss should be increased by any cumulative dividends for the period on these preferred stocks. If interest or preferred dividends are cumulative only if earned, no adjustment of this type is required, except to the extent of income available therefor. If interest or preferred dividends are not cumulative, only the interest accruable or dividends declared should be deducted. In all cases, the effect that has been given to rights of senior securities in arriving at the earnings per share should be disclosed.

51. *Use of "if converted" method of computation.* If convertible securities are deemed to be common stock equivalents for the purpose of computing primary earnings per share, or are assumed to have been converted for the purpose of computing fully diluted earnings per share, the securities should be assumed to have been converted at the beginning of the earliest period reported (or at time of issuance, if later). Interest charges applicable to convertible securities and non-discretionary adjustments that would have been made to items based on net income or income before taxes—such as profit sharing expense, certain royalties, and investment credit—or preferred dividends applicable to the convertible securities should be taken into account in determining the balance of income applicable to common stock. As to primary earnings per share this amount should be divided by the total of the average outstanding common shares and the number of shares which would have been issued on conversion or exercise of common stock equivalents.[17] As to fully diluted earnings per share this amount should be divided by the total of the average outstanding common shares plus the number

[15] See ARB No. 43, Chapter 7B, *Capital Accounts—Stock Dividends and Stock Split Ups.*

[16] The per share and aggregate amounts of cumulative preferred dividends in arrears should be disclosed.

[17] Determined as to options and warrants by application of the method described in paragraphs 36-38 of this Opinion.

of shares applicable to conversions during the period from the beginning of the period to the date of conversion and the number of shares which would have been issued upon conversion or exercise of any other security which might dilute earnings.

52. The if converted method recognizes the fact that the holders of convertible securities cannot share in distributions of earnings applicable to the common stock unless they relinquish their right to senior distributions. Conversion is assumed and earnings applicable to common stock and common stock equivalents are determined before distributions to holders of these securities.

53. The if converted method also recognizes the fact that a convertible issue can participate in earnings, through dividends or interest, either as a senior security or as a common stock, but not both. The two-class method (see paragraph 55) does not recognize this limitation and may attribute to common stock an amount of earnings per share less than if the convertible security had actually been converted. The amount of earnings per share on common stock as computed under the two-class method is affected by the amount of dividends declared on the common stock.

54. *Use of "two-class" method of computation.* Although the two-class method is considered inappropriate with respect to the securities described in paragraph 51, its use may be necessary in the case of participating securities and two-class common stock. (See paragraphs 59-60 for discussion of these securities.) This is the case, for example, when these securities are not convertible into common stock.

55. Under the two-class method, common stock equivalents are treated as common stock with a dividend rate different from the dividend rate on the common stock and, therefore, conversion of convertible securities is not assumed. No use of proceeds is assumed. Distributions to holders of senior securities, common stock equivalents and common stock are first deducted from net income. The remaining amount (the undistributed earnings) is divided by the total of common shares and common share equivalents. Per share distributions to the common stockholders are added to this per share amount to arrive at primary earnings per share.

56. *Delayed effectiveness and changing conversion rates or exercise prices.* In some cases, a conversion option does not become effective until a future date; in others conversion becomes more (or less) advantageous to the security holder at some later date as the conversion rate increases (or decreases), generally over an extended period. For example, an issue may be convertible into one share of common stock in the first year, 1.10 shares in the second year, 1.20 shares in the third year, etc. Frequently, these securities receive little or no cash dividends. Hence, under these circumstances, their value is derived principally from their conversion or exercise option and they would be deemed to be common stock equivalents under the yield test previously described. (See paragraph 33 of this Opinion.)[18] Similarly, the right to exercise options or warrants may be deferred or the exercise price may increase or decrease.

57. *Conversion rate or exercise price to be used—primary earnings per share.* The conversion rate or exercise price of a common stock equivalent in effect during each period presented should be used in computing primary earnings per share, with the exceptions stated hereinafter in this paragraph. Prior period primary earnings per share should not be restated for changes in the conversion ratio or exercise price. If options, warrants or other common stock equivalents are not immediately exercisable or convertible, the earliest effective exercise price or conversion rate if any during the succeeding five years should be used. If a convertible security having an increasing conversion rate is issued in exchange for another class of security of the issuing company and is convertible back into the same or a similar security, and if a conversion rate equal to or greater than the original exchange rate becomes effective during the period of convertibility, the conversion rate used in the computation should not result in a reduction in the number of common shares (or common share equivalents) existing before the original exchange took place until a greater rate becomes effective.

58. *Conversion rate or exercise price to be used—fully diluted earnings per share.* Fully diluted earnings per share computations should be based on the most advantageous (from the standpoint of the security holder) conversion or exercise rights that become effective within ten years following the closing date of the period being

[18] An increasing conversion rate should not be accounted for as a stock dividend.

reported upon.[19] Conversion or exercise options that are not effective until after ten or more years may be expected to be of limited significance because (a) investors' decisions are not likely to be influenced substantially by events beyond ten years, and (b) it is questionable whether they are relevant to current operating results.

59. *Participating securities and two-class common.* The capital structures of some companies include:

a. Securities which may participate in dividends with common stocks according to a predetermined formula (for example, two for one) with, at times, an upper limit on the extent of participation (for example, up to but not beyond a specified amount per share).

b. A class of common stock with different dividend rates or voting rights from those of another class of common stock, but without prior or senior rights.

Additionally, some of these securities are convertible into common stock. Earnings per share computations relating to certain types of participating securities may require the use of the two-class method. (See paragraphs 54-55.)

60. Because of the variety of features which these securities possess, frequently representing combinations of the features referred to above, it is not practicable to set out specific guidelines as to when they should be considered common stock equivalents. Dividend participation does not *per se* make a security a common stock equivalent. A determination of the status of one of these securities should be based on an analysis of all the characteristics of the security, including the ability to share in the earnings potential of the issuing corporation on substantially the same basis as the common stock.

61. *Issuance contingent on certain conditions.* At times, agreements call for the issuance of additional shares contingent upon certain conditions being met. Frequently these conditions are either:

a. the maintenance of current earnings levels, or

b. the attainment of specified increased earnings.

Alternatively, agreements sometimes provide for immediate issuance of the maximum number of shares issuable in the transaction with some to be placed in escrow and later returned to the issuer if specified conditions are not met. For purposes of computing earnings per share, contingently returnable shares placed in escrow should be treated in the same manner as contingently issuable shares.

62. If attainment or maintenance of a level of earnings is the condition, and if that level is currently being attained, the additional shares should be considered as outstanding for the purpose of computing both primary and fully diluted earnings per share. If attainment of increased earnings reasonably above the present level or maintenance of increased earnings above the present level over a period of years is the condition, the additional shares should be considered as outstanding only for the purpose of computing fully diluted earnings per share (but only if dilution is the result); for this computation, earnings should be adjusted to give effect to the increase in earnings specified by the particular agreements (if different levels of earnings are specified, the level that would result in the largest potential dilution should be used). Previously reported earnings per share data should not be restated to give retroactive effect to shares subsequently issued as a result of attainment of specified increased earnings levels. If upon expiration of the term of the agreement providing for contingent issuance of additional shares the conditions have not been met, the shares should not be considered outstanding in that year. Previously reported earnings per share data should then be restated to give retroactive effect to the removal of the contingency.

63. The number of shares contingently issuable may depend on the market price of the stock at a future date. In such a case, computations of earnings per share should reflect the number of shares which would be issuable based on the market price at the close of the period being reported on. Prior period earnings per share should be restated if the number of shares issued or contingently issuable subsequently changes because the market price changes.

64. In some cases, the number of shares contingently issuable may depend on both future earnings and future prices of the shares. In that case, the number of shares which would be issuable should be based

[19] The conversion rate should also reflect the cumulative effect of any stock dividends on the preferred stock which the company has contracted or otherwise committed itself to issue within the next ten years.

on both conditions, that is, market prices and earnings to date as they exist at the end of each period being reported on. (For example, if (a) a certain number of shares will be issued at the end of three years following an acquisition if earnings of the acquired company increase during those three years by a specified amount and (b) a stipulated number of additional shares will be issued if the value of the shares issued in the acquisition is not at least a designated amount at the end of the three-year period, the number of shares to be included in the earnings per share for each period should be determined by reference to the cumulative earnings of the acquired company and the value of the shares at the end of the latest period.) Prior-period earnings per share should be restated if the number of shares issued or contingently issuable subsequently changes from the number of shares previously included in the earnings per share computation.

65. *Securities of subsidiaries.* At times subsidiaries issue securities which should be considered common stock equivalents from the standpoint of consolidated and parent company financial statements for the purpose of computing earnings per share. This could occur when convertible securities, options, warrants or common stock issued by the subsidiary are in the hands of the public and the subsidiary's results of operations are either consolidated or reflected on the equity method. Circumstances in which conversion or exercise of a subsidiary's securities should be assumed for the purpose of computing the consolidated and parent company earnings per share, or which would otherwise require recognition in the computation of earnings per share data, include those where:

As to the Subsidiary

a. Certain of the subsidiary's securities are common stock equivalents in relation to its own common stock.

b. Other of the subsidiary's convertible securities, although not common stock equivalents in relation to its own common stock, would enter into the computation of its fully diluted earnings per share.

As to the Parent

a. The subsidiary's securities are convertible into the parent company's common stock.

b. The subsidiary issues options and warrants to purchase the parent company's common stock.

The treatment of these securities for the purpose of consolidated and parent company reporting of earnings per share is discussed in the following four paragraphs.

66. If a subsidiary has dilutive warrants or options outstanding or dilutive convertible securities which are common stock equivalents from the standpoint of the subsidiary, consolidated and parent company primary earnings per share should include the portion of the subsidiary's income that would be applicable to the consolidated group based on its holdings and the subsidiary's primary earnings per share. (See paragraph 39 of this Opinion.)

67. If a subsidiary's convertible securities are not common stock equivalents from the standpoint of the subsidiary, only the portion of the subsidiary's income that would be applicable to the consolidated group based on its holdings and the fully diluted earnings per share of the subsidiary should be included in consolidated and parent company fully diluted earnings per share. (See paragraph 40 of this Opinion.)

68. If a subsidiary's securities are convertible into its parent company's stock, they should be considered among the common stock equivalents of the parent company for the purpose of computing consolidated and parent company primary and fully diluted earnings per share if the conditions set forth in paragraph 33 of this Opinion exist. If these conditions do not exist, the subsidiary's convertible securities should be included in the computation of the consolidated and parent company fully diluted earnings per share only.

69. If a subsidiary issues options or warrants to purchase stock of the parent company, they should be considered common stock equivalents by the parent in computing consolidated and parent company primary and fully diluted earnings per share.

70. *Dividends per share.* Dividends constitute historical facts and usually are so reported. However, in certain cases, such as those affected by stock dividends or splits or reverse splits, the presentation of dividends per share should be made in terms of the current equivalent of the number of common shares outstanding at the time of the dividend. A disclosure problem exists in presenting data as to dividends per share following a pooling of interests. In such cases, it is usually preferable to disclose the dividends declared per share by the principal constituent and to disclose, in addition, either the amount per equivalent share

or the total amount for each period for the other constituent, with appropriate explanation of the circumstances. When dividends per share are presented on other than an historical basis, the basis of presentation should be disclosed.

APPENDIX B

SUMMARY OF DIFFERING VIEWPOINTS

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This Appendix contains a summary of various viewpoints on a number of matters relating to the computation of earnings per share data, which viewpoints differ from the conclusions of the Board as stated in this Opinion. The views in this Appendix therefore do not represent the views of the Board as a whole.

Common Stock Equivalent or Residual Concept

71. This Opinion concludes (paragraph 26) that, for purposes of computing primary earnings per share, certain securities should be considered the equivalent of common stock. The Opinion further concludes (paragraph 28) that such treatment—as to convertible securities—should be based on a determination of status made at the time of issuance of each security, based on conditions existing at that date and not subsequently changed. Viewpoints which differ from those conclusions are based on a number of positions, which are summarized below.

Concept Has No Validity

72. Some believe there should be no such category as "common stock equivalent" or "residual" security, and hence no such classification as "primary" earnings per share including such securities. They contend that the common stock equivalent or residual security concept involves assumptions and arbitrary, intricate determinations which result in figures of questionable meaning which are more likely to confuse than enlighten readers. They advocate that earnings per share data be presented in a tabulation—as part of the financial statements—which first discloses the relationship of net income and the number of common shares actually outstanding and then moves through adjustments to determine adjusted net income and the number of common shares which would be outstanding if all conver-

sions, exercises and contingent issuances took place. Under this approach, all the figures involved would be readily determinable, understandable and significant. Such information, together with the other disclosures required in this Opinion regarding the terms of securities, would place the reader in a position to make his own judgment regarding prospects of conversion or exercise and the resulting impact on per share earnings. Accounting should not make or pre-empt that judgment.

73. Until convertible securities, etc., are in fact converted, the actual common stockholders are in control, and the entire earnings could often be distributed as dividends. The conversions, exercises and contingent issuances may, in fact, never take place. Hence, the reporting as "primary" earnings per share of an amount which results from treating as common stock securities which are not common stock is, in the view of some, improper.

Concept Has Validity Both At Issuance and Subsequently

74. Some who believe in the validity of the common stock equivalent or residual concept feel that the status of a security should be determined not only at the time of its issuance but from time to time thereafter. Securities having the characteristics associated with residual securities—among other things the ability to participate in the economic benefits resulting from the underlying earnings and earnings potential of the common stock through the right of their holders to become common stock holders—do change their nature with increases and decreases in the market value of the common stock after issuance. These securities are designed for this purpose, and therefore, in certain circumstances, they react to changes in the earnings or earnings potential of the issuer just as does the common stock. Furthermore, although many such securities are issued under market and yield conditions which do not place major emphasis at the time of issuance on their common stock characteristics, both the issuer and the holder recognize the possibility that these characteristics may become of increasing significance if, and when, the value of the underlying common stock increases. The limitation of the residual concept for convertible securities to "at issuance only" disregards these significant factors. (For example, a convertible security with a cash yield of 4% at time of issuance [assumed to be in excess of the yield test for common stock equivalent status in this Opinion] may well appreciate in value subsequent to issuance, due to its common stock characteristics, to such an extent that its cash yield will drop to 2% or less. It seems unsound to consider such a security a "senior security" for earnings per share purposes at such later dates merely because its yield at date of issuance—possibly years previously—was 4%. This seems particularly unwise when the investment community evaluates such a security currently as the substantial equivalent of the common stock into which it is convertible.) Thus, the "at issuance only" application of the residual security concept is, in the opinion of some, illogical and arbitrary. In connection with the computation of earnings per share data, this approach disregards current conditions in reporting a financial statistic whose very purpose is a reflection of the *current* substantive relationship between the earnings of the issuer and its complex capital structure.

75. Furthermore, the adoption of the treasury stock method to determine the number of shares to be considered as common stock equivalents under outstanding options and warrants (see paragraphs 36-38) is apparent recognition of the fact that market conditions subsequent to issuance should influence the determination of the status of a security. Thus, the conclusions of the Opinion in these matters are inconsistent.

76. As for the contention that use of the residual concept subsequent to issuance has a "circular" effect—in that reported earnings per share influences the market, which, in turn, influences the classification status of a security, which, in turn, influences the computation of earnings per share, which, in turn, influences the market—analysts give appropriate recognition to the increasing importance of the common stock characteristics of convertible securities as the market rises or falls. It seems only appropriate that a computation purporting to attribute the earnings of a corporation to the various components of its capital structure should also give adequate recognition to the changing substance of these securities. Thus, the movement of securities in and out of residual status subsequent to their issuance is a logical and integral part of the entire concept.

77. As for the contention that the dual presentation of earnings per share data required by this Opinion appropriately reflects the dilutive effect of any convertible securities which were not residual at time

of issuance but which might subsequently be considered as residual, the disclosure of "fully-diluted" earnings per share data is aimed at *potential* (i.e., possible future) dilution; for issuers with securities having extremely low yields of the levels described in the preceding paragraph, the dilution has already taken place—these common stock equivalents are being so traded in the market, and any method which does not reflect these conditions results in an amount for "primary earnings per share" which may be misleading. Furthermore, whenever an issuer has more than one convertible security outstanding, the effect of even the "potential" dilution of such "residual" securities is not appropriately reflected in any meaningful manner in the fully-diluted earnings per share amount, since its impact is combined with that of other convertible securities of the issuer which may not currently be "residual".

Criteria and Methods for Determination of Residual Status

78. This Opinion concludes (paragraph 33) that a cash yield test—based on a specified percentage of the bank prime interest rate—should be used to determine the residual status of convertible securities, and that options and warrants should be considered residual securities at all times. Viewpoints differing from those conclusions and supporting other criteria or methods are summarized below.

Convertible Securities

79. *Investment value method.* As explained in paragraphs 8-11 of this Opinion, a previous Opinion specified a relative value method for the determination of the residual status of a security. In practice the method has been applied by comparing the market value of a convertible security with its "investment value", and by classifying a security as residual at time of issuance if such market value were 200% or more of investment value, with certain practical modifications of this test subsequent to time of issuance to assure the substance of an apparent change in status and to prevent frequent changes of status for possible temporary fluctuations in the market.

80. The establishment of investment values for convertible securities involves considerable estimation, and frequently requires the use of experts. Published financial services report estimates of investment value for many, but not all, convertible securities. Most convertible securities are issued under conditions which permit a reasonable estimate of their investment values. In addition, reference to the movements of long-term borrowing rates for groups of issuers with similar credit and risk circumstances—or even reference to general long-term borrowing rates—can furnish effective evidence for an appropriate determination of the investment value of a convertible security subsequent to its issuance. As in many determinations made for accounting purposes, estimates of this nature are often necessary. The necessity of establishing some percentage or level as the line of demarcation between residual and non-residual status is common to all methods under consideration —including the market parity test and various yield tests—and appears justifiable in the interest of reasonable consistency of treatment, both for a single issuer and among issuers.

81. The investment value method is somewhat similar to the cash yield method specified in paragraph 33 of this Opinion. However, the latter method has two apparent weaknesses, in the view of those who support the investment value method. In the first place, it does not differentiate between issuers—that is, it is based on the same borrowing rate for all issuers, without regard for their credit ratings or other risks inherent in their activities. Second, it is based on the current bank prime interest rate, which is essentially a short-term borrowing rate. The relationship between this rate—assuming that it is constant in all sections of the country at any given time—and the long-term corporate borrowing rate may fluctuate to such an extent that the claimed ease of determination may be offset by a lack of correlation. The investment value method, based on the terms of each issue and the status of each issuer, is thus considered by some to be a more satisfactory method.

82. *Market parity method.* This method compares a convertible security's market value with its conversion value. In general, if the two values are substantially equivalent and in excess of redemption price, the convertible security is considered to be "residual".

83. The market parity method has the advantage, as compared to the investment value method, of using amounts that usually are readily available or ascertainable, and of avoiding estimates of investment value. More importantly, in the view of some, the equivalence of values is clearly an indication of the equivalence of the securities, while

a comparison of relative values of the characteristics of a security is an indication of its status only if arbitrary rules, such as the "major portion of value" test, are used. In similar vein, the yield test also requires the establishment of a point at which to determine residuality. On the other hand, a practical application of the market parity test would also require the establishment of a percentage relationship at which to determine residual status, due to the many variables involved and the need for consistent application. Also, the call or redemption price of a convertible security has an effect on the point at which market parity is achieved.

84. *Yield methods.* There are various other methods of determining the residual nature of a convertible security based on yield relationships. Each of these is based on a comparison of the cash yield on the convertible security (based on its market value) and some predetermined rate of yield (based on other values, conditions or ratings). The discussion of the various methods contained in this Opinion comprehends the advantages and disadvantages of these other methods.

Options and Warrants

85. As explained in paragraphs 35-38 of this Opinion, options and warrants should be regarded as common stock equivalents at all times; the "treasury stock method" should be used in most cases to determine the number of common shares to be considered the equivalent of the options and warrants; and the number of common shares so computed should be included in the computation of both the "primary" and "fully-diluted" earnings per share (assuming a dilutive effect). Viewpoints which differ from those conclusions and support other treatments or other methods of measurement are summarized below.

86. *Exclusion from computation of primary earnings per share.* In this Opinion the Board has for the first time considered options and warrants to be common stock equivalents at all times and, because of the treasury stock method of computation established, the primary earnings per share will in some cases be affected by the market price of the stock obtainable on exercise, rather than solely by the economics of the transaction entered into. Some believe that this produces a circular effect in that the reporting of earnings per share may then influence the market which, in turn, influences earnings per share. They believe that earnings per share should affect the market and not vice versa. They point out that the classification of convertible debentures and convertible preferred stocks is determined at time of issuance only and consequently subsequent fluctuations in the market prices of these securities do not affect primary earnings per share. Therefore, they believe that the dual, equally prominent presentation of primary and fully diluted earnings per share is most informative when the effect of options and warrants, other than those whose exercise price is substantially lower than market price at time of issuance, is included only in the fully diluted earnings per share which would be lower than primary earnings per share and thus would emphasize the potential dilution.

87. *Determination of equivalent common shares.* Some believe that the "treasury stock method" described in paragraph 36 of the Opinion is unsatisfactory and that other methods are preferable. Under one such method the number of equivalent shares is computed by reference to the relationship between the market value of the option or warrant and the market value of the related common stock. In general, it reflects the impact of options and warrants on earnings per share whenever the option or warrant has a market value, and not only when the market price of the related common stock exceeds the exercise price (as does the treasury stock method).

88. *Measurement of effect of options and warrants.* Some believe that the effect of outstanding options and warrants on earnings per share should be computed by assuming exercise as of the beginning of the period and assuming some use of the funds so attributed to the issuer. The uses which have been suggested include application of such assumed proceeds to (a) reduce outstanding short or long term borrowings, (b) invest in government obligations or commercial paper, (c) invest in operations of the issuer or (d) fulfill other corporate objectives of the issuer. Each of these methods is felt by some to be the preferable approach. Many who support one of these methods feel that the "treasury stock method" is improper since (a) it fails to reflect any dilution unless the market price of the common stock exceeds the exercise price, (b) it assumes a hypothetical purchase of treasury stock which in many cases—due to the significant number of common shares involved—would either not be possible or be possible only at a con-

siderably increased price per share, and (c) it may be considered to be the attribution of earnings assumed on the funds received —in which case the earnings rate for each issuer is a function of the price-earnings ratio of its common stock and is thus similar in result to an arbitrary assumption of a possibly inappropriate earnings rate.

89. Some believe that no increment in earnings should be attributed to the funds assumed to be received upon the exercise of options and warrants, particularly if such instruments are to be reflected in the computation of primary earnings per share, since the funds were not available to the issuer during the period.

Computational Methods—Convertible Securities

90. This Opinion concludes (paragraph 51) that the "if converted" method of computation should be used for primary earnings per share when convertible securities are considered the equivalent of common stock. Some believe that this method does not properly reflect the actual circumstances existing during the period, and favor, instead, the so-called "two-class" method of computation. (See paragraphs 54-55.) Under the latter method, securities considered common stock equivalents are treated as common shares with a different dividend rate from that of the regular common shares. The residual security concept is based on common stock equivalence without the necessity of actual conversion; therefore, this method properly recognizes the fact that these securities receive a preferential distribution before the common stock—and also share in the potential benefits of the undistributed earnings through their substantial common stock characteristics in the same way as do the common shares. These securities are designed to achieve these two goals. Those who favor this method believe that the "if converted" method disregards the realities of what occurred during the period. Thus, in their view, the "if converted" method is a "proforma" method which assumes conversion and the elimination of preferential distributions to these securities; as such, it is not suitable for use in the computation of *primary earnings per share data,* since the assumed conversions did not take place and the preferential distributions did take place.

91. Those who favor the "two-class" method point out that it is considered appropriate in the case of certain participating and two-class common situations. In their view, the circumstances existing when common stock equivalents are outstanding are similar; therefore, use of this method is appropriate.

Recognition of Common Stock Equivalents in the Financial Statements

92. This Opinion concludes (paragraph 39) that the designation of securities as common stock equivalents is solely for the purpose of determining primary earnings per share; no changes from present practice are recommended in the presentation of such securities in the financial statements. Some believe, however, that the financial statements should reflect a treatment of such securities which is consistent with the method used to determine earnings per share in the financial statements. Accordingly, convertible debt considered to be a common stock equivalent would be classified in the balance sheet in association with stockholders' equity—either under a separate caption immediately preceding stockholders' equity, or in a combined section with a caption such as "Equity of common stockholders and holders of common stock equivalents". In the statement of income and retained earnings, interest paid on convertible debt considered a common stock equivalent would be shown as a "distribution to holders of common stock equivalents", either following the caption of "net income" in the statement of income or grouped with other distributions in the statement of retained earnings.

93. Some believe that the inconsistency of the positions taken on this matter in this Opinion is clearly evident in the requirement (paragraph 66) that, when a subsidiary has convertible securities which are common stock equivalents, the portion of the income of the subsidiary to be included in the consolidated statement of income of the parent and its subsidiaries should be computed disregarding the effect of the common stock equivalents, but that the computation of the primary earnings per share of the parent should reflect the effect of these common stock equivalents in attributing the income of the subsidiary to its various outstanding securities. This inconsistent treatment is, in the opinion of some, not only illogical but misleading.

APPENDIX C

ILLUSTRATIVE STATEMENTS

The following exhibits illustrate the disclosure of earnings per share data on the assumption that this Opinion was effective for all periods covered. The format of the disclosure is illustrative only, and does not necessarily reflect a preference by the Accounting Principles Board.

Exhibit A. This exhibit illustrates the disclosure of earnings per share data for a company with a simple capital structure (see paragraph 14 of this Opinion). The facts assumed for Exhibit A are as follows:

	Number of Shares *1968*	*1967*
Common stock outstanding:		
Beginning of year	3,300,000	3,300,000
End of year	3,300,000	3,300,000
Issued or acquired during year	None	None
Common stock reserved under employee stock options granted	7,200	7,200
Weighted average number of shares	3,300,000	3,300,000

NOTE: Shares issuable under employee stock options are excluded from the weighted average number of shares on the assumption that their effect is not dilutive (see paragraph 14 of this Opinion).

EXHIBIT A

EXAMPLE OF DISCLOSURE OF EARNINGS PER SHARE
Simple Capital Structure

(Bottom of Income Statement)	*Thousands Except per share data* *1968*	*1967*
Income before extraordinary item	$ 9,150	$7,650
Extraordinary item—gain on sale of property less applicable income taxes	900	.....
Net Income	$10,050	$7,650
Earnings per common share:		
Income before extraordinary item	$ 2.77	$ 2.32
Extraordinary item	.28	.....
Net Income	$ 3.05	$ 2.32

Exhibit B. This exhibit illustrates the disclosure of earnings per share data for a company with a complex capital structure (see paragraph 15 of this Opinion). The facts assumed for Exhibit B are as follows:

Market price of common stock. The market price of the common stock was as follows:

Average Price:	*1968*	*1967*	*1966*
First quarter	50	45	40
Second quarter	60	52	41
Third quarter	70	50	40
Fourth quarter	70	50	45
December 31 closing price	72	51	44

Cash dividends. Cash dividends of $0.125 per common share were declared and paid for each quarter of 1966 and 1967. Cash dividends of $0.25 per common share were declared and paid for each quarter of 1968.

Convertible debentures. 4% convertible debentures with a principal amount of $10,000,000 due 1986 were sold for cash at a price of 100 in the last quarter of 1966. Each $100 debenture was convertible into two shares of common stock. No debentures were converted during 1966 or 1967. The entire issue was converted at the beginning of the third quarter of 1968 because the issue was called by the company.

These convertible debentures were not common stock equivalents under the terms of this Opinion. The bank prime rate at the time the debentures were sold in the last quarter of 1966 was 6%. The debentures carried a coupon interest rate of 4% and had a market value of $100 at issuance. The cash yield of 4% was not less than 66⅔% of the bank prime rate (see paragraph 33 of this Opinion). Cash yield is the same as the coupon interest rate in this case only because the market value at issuance was $100.

Convertible preferred stock. 600,000 shares of convertible preferred stock were issued for assets in a purchase transaction at the beginning of the second quarter of 1967. The annual dividend on each share of this convertible preferred stock is $0.20. Each share is convertible into one share of common stock. This convertible stock had a market value of $53 at the time of issuance and was therefore a common stock equivalent under the terms of this Opinion at the time of its issuance because the cash yield on market value was only 0.4% and the bank prime rate was 5.5% (see paragraph 33 of this Opinion).

Holders of 500,000 shares of this convertible preferred stock converted their preferred stock into common stock during 1968 because the cash dividend on the common stock exceeded the cash dividend on the preferred stock.

Warrants. Warrants to buy 500,000 shares of common stock at $60 per share for a period of five years were issued along with the convertible preferred stock mentioned above. No warrants have been exercised. (Note that the number of shares issuable upon exercise of the warrants is less than 20% of outstanding common shares; hence paragraph 38 is not applicable.)

The number of common shares represented by the warrants (see paragraph 36 of this Opinion) was 71,428 for each of the third and fourth quarters of 1968 ($60 exercise price × 500,000 warrants = $30,000,000; $30,000,000 ÷ $70 share market price = 428,572 shares; 500,000 shares — 428,572 shares = 71,428 shares). No shares were deemed to be represented by the warrants for the second quarter of 1968 or for any preceding quarter (see paragraph 36 of this Opinion) because the market price of the stock did not exceed the exercise price for substantially all of three consecutive months until the third quarter of 1968.

Common stock. The number of shares of common stock outstanding were as follows:

	1968	*1967*
Beginning of year	3,300,000	3,300,000
Conversion of preferred stock	500,000	....
Conversion of debentures	200,000	....
End of year	4,000,000	3,300,000

Weighted average number of shares. The weighted average number of shares of common stock and common stock equivalents was determined as follows:

	1968	1967
Common stock:		
Shares outstanding from beginning of period	3,300,000	3,300,000
500,000 shares issued on conversion of preferred stock; assume issuance evenly during year	250,000	....
200,000 shares issued on conversion of convertible debentures at beginning of third quarter of 1968	100,000	....
	3,650,000	3,300,000
Common stock equivalents:		
600,000 shares convertible preferred stock issued at the beginning of the second quarter of 1967, excluding 250,000 shares included under common stock in 1968	350,000	450,000
Warrants: 71,428 common share equivalents outstanding for third and fourth quarters of 1968, i.e. one-half year	35,714	....
	385,714	450,000
Weighted average number of shares	4,035,714	3,750,000

The weighted average number of shares would be adjusted to calculate fully diluted earnings per share as follows:

	1968	1967
Weighted average number of shares	4,035,714	3,750,000
Shares applicable to convertible debentures converted at the beginning of the third quarter of 1968, excluding 100,000 shares included under common stock for 1968	100,000	200,000
Shares applicable to warrants included above	(35,714)	....
Shares applicable to warrants based on year-end price of $72 (see paragraph 42 of this Opinion)	83,333	....
	4,183,333	3,950,000

Income before extraordinary item and net income would be adjusted for interest expense on the debentures in calculating fully diluted earnings per share as follows:

	Thousands		
	Before Adjustment	*Interest, net of tax effect*	*After Adjustment*
1967: Net income	$10,300	$208	$10,508
1968:			
Income before extraordinary item	12,900	94	12,994
Net income	13,800	94	13,894

NOTES: (a) Taxes in 1967 were 48%; in 1968 they were 52.8%. (b) Net income is before dividends on preferred stock.

EXHIBIT B

EXAMPLE OF DISCLOSURE OF EARNINGS PER SHARE
Complex Capital Structure

(Bottom of Income Statement)	*Thousands Except per share data* *1968*	*1967*
Income before extraordinary item	$12,900	$10,300
Extraordinary item—gain on sale of property less applicable income taxes	900	—
Net Income	$13,800	$10,300
Earnings per common share and common equivalent share (note x):		
Income before extraordinary item	$ 3.20	$ 2.75
Extraordinary item	.22	—
Net Income	$ 3.42	$ 2.75
Earnings per common share—assuming full dilution (note x):		
Income before extraordinary item	$ 3.11	$ 2.66
Extraordinary item	.21	—
Net Income	$ 3.32	$ 2.66

EXHIBIT C

EXAMPLE OF NOTE X* TO EXHIBIT B

The $0.20 convertible preferred stock is callable by the company after March 31, 1972 at $53 per share. Each share is convertible into one share of common stock.

During 1968, 700,000 shares of common stock were issued on conversions: 500,000 shares on conversion of preferred stock and 200,000 on conversion of all the 4% convertible debentures.

Warrants to acquire 500,000 shares of the company's stock at $60 per share were outstanding at the end of 1968 and 1967. These warrants expire March 31, 1972.

Earnings per common share and common equivalent share were computed by dividing net income by the weighted average number of shares of common stock and common stock equivalents outstanding during the year. The convertible preferred stock has been considered to be the equivalent of common stock from the time of its issuance in 1967. The number of shares issuable on conversion of preferred stock was added to the number of common shares. The number of common shares was also increased by the number of shares issuable on the exercise of warrants when

* The following disclosure in the December 31, 1968 balance sheet is assumed for this note:

	1968	1967
Long-term debt:		
4% convertible debentures, due 1986	....	$10,000,000
Stockholders' equity (note x):		
Convertible voting preferred stock of $1 par value, $0.20 cumulative dividend. Authorized 600,000 shares; issued and outstanding 100,000 shares (600,000 in 1967)	$ 100,000	$ 600,000
(Liquidation value $22 per share, aggregating $2,200,000 in 1968 and $13,200,000 in 1967)		
Common stock of $1 par value per share. Authorized 5,000,000 shares; issued and outstanding 4,000,000 shares (3,300,000 in 1967)	4,000,000	3,300,000
Additional paid-in capital	xxx	xxx
Retained earnings	xxx	xxx
	$ xxx	$ xxx

the market price of the common stock exceeds the exercise price of the warrants. This increase in the number of common shares was reduced by the number of common shares which are assumed to have been purchased with the proceeds from the exercise of the warrants; these purchases were assumed to have been made at the average price of the common stock during that part of the year when the market price of the common stock exceeded the exercise price of the warrants.

Earnings per common share and common equivalent share for 1968 would have been $3.36 for net income and $3.14 for income before extraordinary item had the 4% convertible debentures due 1986 been converted on January 1, 1968. (These debentures were called for redemption as of July 1, 1968 and all were converted into common shares.)

Earnings per common share—assuming full dilution for 1968 were determined on the assumptions that the convertible debentures were converted and the warrants were exercised on January 1, 1968. As to the debentures, net earnings were adjusted for the interest net of its tax effect. As to the warrants, outstanding shares were increased as described above except that purchases of common stock are assumed to have been made at the year-end price of $72.

Earnings per common share—assuming full dilution for 1967 were determined on the assumption that the convertible debentures were converted on January 1, 1967. The outstanding warrants had no effect on the earnings per share data for 1967, as the exercise price was in excess of the market price of the common stock.

APPENDIX D

DEFINITIONS OF TERMS

There are a number of terms used in discussion of earnings per share which have special meanings in that context. When used in this Opinion they are intended to have the meaning given in the following definitions. Some of the terms are not used in the Opinion but are provided as information pertinent to the subject of earnings per share.

Call price. The amount at which a security may be redeemed by the issuer at the issuer's option.

Cash yield. The cash received by the holder of a security as a distribution of accumulated or current earnings or as a contractual payment for return on the amount invested, without regard to the par or face amount of the security. As used in this Opinion the term "cash yield" refers to the relationship or ratio of such cash to be received annually to the market value of the related security at the specified date. For example, a security with a coupon rate of 4% (on par of $100) and a market value of $80 would have a cash yield of 5%.

Common stock. A stock which is subordinate to all other stocks of the issuer.

Common stock equivalent. A security which, because of its terms or the circumstances under which it was issued, is in substance equivalent to common stock.

Contingent issuance. A possible issuance of shares of common stock that is dependent upon the exercise of conversion rights, options or warrants, the satisfaction of certain conditions, or similar arrangements.

Conversion price. The price that determines the number of shares of common stock into which a security is convertible. For example, $100 face value of debt convertible into 5 shares of common stock would be stated to have a conversion price of $20.

Conversion rate. The ratio of (a) the number of common shares issuable upon conversion to (b) a unit of a convertible security. For example, a preferred stock may be convertible at the rate of 3 shares of common stock for each share of preferred stock.

Conversion value. The current market value of the common shares obtainable upon conversion of a convertible security, after deducting any cash payment required upon conversion.

Dilution (Dilutive). A reduction in earnings per share resulting from the assumption that convertible securities have been converted or that options and warrants have been exercised or other shares have been issued upon the fulfillment of certain conditions. (See footnote 2.)

Dual presentation. The presentation with equal prominence of two types of earnings per share amounts on the face of the income statement—one is primary earnings per share; the other is fully diluted earnings per share.

Earnings per share. The amount of earnings attributable to each share of common stock. For convenience, the term is used in this Opinion to refer to either net income (earnings) per share or to net loss per share. It should be used without qualifying language only when no potentially dilutive convertible securities, options, warrants or other agreements providing for contingent issuances of common stock are outstanding.

Exercise price. The amount that must be paid for a share of common stock upon exercise of a stock option or warrant.

Fully diluted earnings per share. The amount of current earnings per share reflecting the maximum dilution that would have resulted from conversions, exercises and other contingent issuances that individually would have decreased earnings per share and in the aggregate would have had a dilutive effect. All such issuances are assumed to have taken place at the beginning of the period (or at the time the contingency arose, if later).

"If converted" method. A method of computing earnings per share data that assumes conversion of convertible securities as of the beginning of the earliest period reported (or at time of issuance, if later).

Investment value. The price at which it is estimated a convertible security would sell if it were not convertible, based upon its stipulated preferred dividend or interest rate and its other senior security characteristics.

Market parity. A market price relationship in which the market price of a convertible security and its conversion value are approximately equal.

Option. The right to purchase shares of common stock in accordance with an agreement, upon payment of a specified amount. As used in this Opinion, options include but are not limited to options granted to and stock purchase agreements entered into with employees. Options are considered "securities" in this Opinion.

Primary earnings per share. The amount of earnings attributable to each share of common stock outstanding, including common stock equivalents.

Redemption price. The amount at which a security is required to be redeemed at maturity or under a sinking fund arrangement.

Security. The evidence of a debt or ownership or related right. For purposes of this Opinion it includes stock options and warrants, as well as debt and stock.

Senior security. A security having preferential rights and which is not a common stock or common stock equivalent, for example, nonconvertible preferred stock.

Supplementary earnings per share. A computation of earnings per share, other than primary or fully diluted earnings per share, which gives effect to conversions, etc., which took place during the period or shortly thereafter as though they had occurred at the beginning of the period (or date of issuance, if later).

Time of issuance. The time of issuance generally is the date when agreement as to terms has been reached and announced, even though such agreement is subject to certain further actions, such as directors' or stockholders' approval.

Treasury stock method. A method of recognizing the use of proceeds that would be obtained upon exercise of options and warrants in computing earnings per share. It assumes that any proceeds would be used to purchase common stock at current market prices. (See paragraphs 36-38).

"Two-class" method. A method of computing primary earnings per share that treats common stock equivalents as though they were common stocks with different dividend rates from that of the common stock.

Warrant. A security giving the holder the right to purchase shares of common stock in accordance with the terms of the instrument, usually upon payment of a specified amount.

Weighted average number of shares. The number of shares determined by relating (a) the portion of time within a reporting period that a particular number of shares of a certain security has been outstanding to (b) the total time in that period. Thus, for example, if 100 shares of a certain security were outstanding during the first quarter of a fiscal year and 300 shares were outstanding during the balance of the year, the weighted average number of outstanding shares would be 250.

APB Opinion No. 16

BUSINESS COMBINATIONS

AUGUST, 1970

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SUMMARY

Problem

1. A business combination occurs when a corporation and one or more incorporated or unincorporated businesses are brought together into one accounting entity. The single entity carries on the activities of the previously separate, independent enterprises.

2. Two methods of accounting for business combinations—"purchase" and "pooling of interests"—have been accepted in practice and supported in pronouncements of the Board and its predecessor, the Committee on Accounting Procedure. The accounting treatment of a combination may affect significantly the reported financial position and net income of the combined corporation for prior, current, and future periods.

3. The Director of Accounting Research of the American Institute of Certified Public Accountants has published two studies on accounting for business combinations and the related goodwill: Accounting Research Study No. 5, *A Critical Study of Accounting for Business Combinations,* by Arthur R. Wyatt and Accounting Research Study No. 10, *Accounting for Goodwill,* by George R. Catlett and Norman O. Olson.[1] The two studies describe the origin and development of the purchase and pooling of interests methods of accounting for business combinations. The studies also cite the supporting authoritative pronouncements and their influences on accounting practices and evaluate the effects of practices on financial reporting.

Scope and Effect of Opinion

4. The Board has considered the conclusions and recommendations of Accounting Research Studies Nos. 5 and 10, the discussions of the need for and appropriateness of the two accepted methods of accounting for business combinations, and proposals for alternative accounting methods. It has also observed the present treatments of combinations in various forms and under differing conditions. The Board expresses in this Opinion its conclusions on accounting for business combinations.

5. This Opinion covers the combination of a corporation and one or more incorporated or unincorporated businesses; both incorporated and unincorporated enterprises are referred to in this Opinion as companies. The conclusions of this Opinion apply equally to business combinations in which one or more companies become subsidiary corporations, one company transfers its net assets to another, and each company transfers its net assets to a newly formed corporation. The acquisition of some or all of the stock held by minority stockholders of a subsidiary is not a business combination, but paragraph 43 of this Opinion specifies the applicable method of accounting. The term business combination in this Opinion excludes a transfer by a corporation of its net assets to a newly formed substitute corporate entity chartered by the existing corporation and a transfer of net assets or exchange of shares between companies under common control (control is described in paragraph 2 of ARB No. 51), such as between a parent corporation and its subsidiary or between two subsidiary corporations of the same parent. This Opinion does not specifically discuss the combination of a corporation and one or more unincorporated businesses or of two or more unincorporated businesses, but its provisions should be applied as a general guide.

6. This Opinion applies to regulated companies in accordance with the provisions of the Addendum to APB Opinion No. 2, *Accounting for the "Investment Credit,"* 1962.

7. The conclusions of this Opinion modify previous views of the Board and its predecessor committee. This Opinion therefore supersedes the following Accounting Research Bulletins (ARB) and Opinions of the Accounting Principles Board (APB):

ARB No. 43, Chapter 5, *Intangible Assets,* paragraph 10.

ARB No. 48, *Business Combinations.*

ARB No. 51, *Consolidated Financial Statements,* paragraphs 7 and 8...

APB Opinion No. 6, *Status of Accounting Research Bulletins,* paragraphs 12c and 22.

APB Opinion No. 10, *Omnibus Opinion—1966,* paragraph 5. Since this Opinion supersedes those existing pronouncements, paragraph 87 of this Opinion should be substituted for the reference to ARB No. 51 in paragraph 49 of APB Opinion No. 11.

Conclusions

8. The Board concludes that the purchase method and the pooling of interests method are both acceptable in accounting for business combinations, although not as alternatives in accounting for the same business

[1] Accounting research studies are not pronouncements of the Board or of the Institute but are published for the purpose of stimulating discussion on important accounting matters.

combination. A business combination which meets specified conditions requires accounting by the pooling of interests method. A new basis of accounting is not permitted for a combination that meets the specified conditions, and the assets and liabilities of the combining companies are combined at their recorded amounts. All other business combinations should be accounted for as an acquisition of one or more companies by a corporation. The cost to an acquiring corporation of an entire acquired company should be determined by the principles of accounting for the acquisition of an asset. That cost should then be allocated to the identifiable individual assets acquired and liabilities assumed based on their fair values; the unallocated cost should be recorded as goodwill.

BACKGROUND

Present Accounting and Its Development

Development of Two Methods

9. Most business combinations before World War II were classified either as a "merger," the acquisition of one company by another, or as a "consolidation," the formation of a new corporation. Accounting for both types of combinations generally followed traditional principles for the acquisition of assets or issuance of shares of stock. The accounting adopted by some new corporations was viewed as a precedent for the combining of retained earnings and of amounts of net assets recorded by predecessor corporations as retained earnings and net assets of a new entity.

10. Emphasis shifted after World War II from the legal form of the combination to distinctions between "a continuance of the former ownership or a new ownership" (ARB No. 40, paragraph 1). New ownership was accounted for as a purchase; continuing ownership was accounted for as a pooling of interests. Carrying forward the stockholders' equity, including retained earnings, of the constituents became an integral part of the pooling of interests method. Significant differences between the purchase and pooling of interests methods accepted today are in the amounts ascribed to assets and liabilities at the time of combination and income reported for the combined enterprise.

Purchase Method[2]

11. The purchase method accounts for a business combination as the acquisition of one company by another. The acquiring corporation records at its cost the acquired assets less liabilities assumed. A difference between the cost of an acquired company and the sum of the fair values of tangible and identifiable intangible assets less liabilities is recorded as goodwill. The reported income of an acquiring corporation includes the operations of the acquired company after acquisition, based on the cost to the acquiring corporation.

Pooling of Interests Method[3]

12. The pooling of interests method accounts for a business combination as the uniting of the ownership interests of two or more companies by exchange of equity securities. No acquisition is recognized because the combination is accomplished without disbursing resources of the constituents. Ownership interests continue and the former bases of accounting are retained. The recorded assets and liabilities of the constituents are carried forward to the combined corporation at their recorded amounts. Income of the combined corporation includes income of the constituents for the entire fiscal period in which the combination occurs. The reported income of the constituents for prior periods is combined and restated as income of the combined corporation.

13. The original concept of pooling of interests as a fusion of equity interests was modified in practice as use of the method expanded.[3] The method was first applied in accounting for combinations of affiliated corporations and then extended to some

[2] This Opinion refers to the "purchase method of accounting" for a business combination because the term is widely used and generally understood. However, the more inclusive terms "acquire" (to come into possession of) and "acquisition" are generally used to describe transactions rather than the more narrow term "purchase" (to acquire by the payment of money or its equivalent). The broader terms clearly encompass obtaining assets by issuing stock as well as by disbursing cash and thus avoid the confusion that results from describing a stock transaction as a "purchase." This Opinion does not describe a business combination accounted for by the pooling of interests method as an "acquisition" because the meaning of the word is inconsistent with the method of accounting.

[3] The origin, development, and application of the pooling of interests method of accounting are traced in Accounting Research Study No. 5 and summarized in Accounting Research Study No. 10.

combinations of unrelated corporate ownership interests of comparable size. The method was later accepted for most business combinations in which common stock was issued. New and complex securities have been issued in recent business combinations and some combination agreements provide for additional securities to be issued later depending on specified events or circumstances. Most of the resulting combinations are accounted for as poolings of interests. Some combinations effected by both disbursing cash and issuing securities are now accounted for as a "part purchase, part pooling."

14. Some accountants believe that the pooling of interests method is the only acceptable method for a combination which meets the requirements for pooling. Others interpret the existing pronouncements on accounting for business combinations to mean that a combination which meets the criteria for a pooling of interests may alternatively be accounted for as a purchase.

Appraisal of Accepted Methods of Accounting

15. The pooling of interests method of accounting is applied only to business combinations effected by an exchange of stock and not to those involving primarily cash, other assets, or liabilities. Applying the purchase method of accounting to business combinations effected by paying cash, distributing other assets, or incurring liabilities is not challenged. Thus, those business combinations effected primarily by an exchange of equity securities present a question of choice between the two accounting methods.

16. The significantly different results of applying the purchase and pooling of interests methods of accounting to a combination effected by an exchange of stock stem from distinct views of the nature of the transaction itself. Those who endorse the pooling of interests method believe that an exchange of stock to effect a business combination is in substance a transaction between the combining stockholder groups and does not involve the corporate entities. The transaction therefore neither requires nor justifies establishing a new basis of accountability for the assets of the combined corporation. Those who endorse the purchase method believe that the transaction is an issue of stock by a corporation for consideration received from those who become stockholders by the transaction. The consideration received is established by bargaining between independent parties, and the acquiring corporation accounts for the additional assets at their bargained—that is, current—values.

Purchase Method

17. The more important arguments expressing the advantages and disadvantages of the purchase method and some of the practical difficulties experienced in implementing it are summarized in paragraphs 18 to 26.

18. *An acquisition.* Those who favor the purchase method of accounting believe that one corporation acquires another company in almost every business combination. The acquisition of one company by another and the identities of the acquiring and acquired companies are usually obvious. Generally, one company in a business combination is clearly the dominant and continuing entity and one or more other companies cease to control their own assets and operations because control passes to the acquiring corporation.

19. *A bargained transaction.* Proponents of purchase accounting hold that a business combination is a significant economic event which results from bargaining between independent parties. Each party bargains on the basis of his assessment of the current status and future prospects of each constituent as a separate enterprise and as a contributor to the proposed combined enterprise. The agreed terms of combination recognize primarily the bargained values and only secondarily the costs of assets and liabilities carried by the constituents. In fact, the recorded costs are not always known by the other bargaining party.

20. Accounting by the purchase method is essentially the same whether the business combination is effected by distributing assets, incurring liabilities, or issuing stock because issuing stock is considered an economic event as significant as distributing assets or incurring liabilities. A corporation must ascertain that the consideration it receives for stock issued is fair, just as it must ascertain that fair value is received for cash disbursed. Recipients of the stock similarly appraise the fairness of the transaction. Thus, a business combination is a bargained transaction regardless of the nature of the consideration.

21. *Reporting economic substance.* The purchase method adheres to traditional principles of accounting for the acquistion of assets. Those who support the purchase method of accounting for business combinations effected by issuing stock believe

that an acquiring corporation accounts for the economic substance of the transaction by applying those principles and by recording:

a. All assets and liabilities which comprise the bargained cost of an acquired company, not merely those items previously shown in the financial statements of an acquired company.

b. The bargained costs of assets acquired less liabilities assumed, not the costs to a previous owner.

c. The fair value of the consideration received for stock issued, not the equity shown in the financial statements of an acquired company.

d. Retained earnings from its operations, not a fusion of its retained earnings and previous earnings of an acquired company.

e. Expenses and net income after an acquisition computed on the bargained cost of acquired assets less assumed liabilities, not on the costs to a previous owner.

22. *Defects attributed to purchase method.* Applying the purchase method to business combinations effected primarily by issuing stock may entail difficulties in measuring the cost of an acquired company if neither the fair value of the consideration given nor the fair value of the property acquired is clearly evident. Measuring fair values of assets acquired is complicated by the presence of intangible assets or other assets which do not have discernible market prices. Goodwill and other unidentifiable intangible assets are difficult to value directly, and measuring assets acquired for stock is easier if the fair value of the stock issued is determinable. The excess of the value of stock issued over the sum of the fair values of the tangible and identifiable intangible assets acquired less liabilities assumed indicates the value of acquired unidentified intangible assets (usually called goodwill).

23. However, the fair value of stock issued is not always objectively determinable. A market price may not be available for a newly issued security or for securities of a closely held corporation. Even an available quoted market price may not always be a reliable indicator of fair value of consideration received because the number of shares issued is relatively large, the market for the security is thin, the stock price is volatile, or other uncertainties influence the quoted price. Further, the determinable value of one security may not necessarily indicate the fair value of another similar, but not identical, security because their differences affect the value—for example, the absence of registration or an agreement which restricts a holder's ability to sell a security may significantly affect its value.

24. Those who oppose applying the purchase method to some or most business combinations effected by stock also challenge the theoretical merits of the method. They contend that the goodwill acquired is stated only by coincidence at the value which would be determined by direct valuation. The weakness is attributed not to measurement difficulties (direct valuation of goodwill is assumed) but to the basis underlying an exchange of shares of stock. Bargaining in that type of transaction is normally based on the market prices of the equity securities. Market prices of the securities exchanged are more likely to be influenced by anticipated earning capacities of the companies than by evaluations of individual assets. The number of shares of stock issued in a business combination is thus influenced by values attributed to goodwill of the acquirer as well as goodwill of the acquired company. Since the terms are based on the market prices of both stocks exchanged, measuring the cost of an acquired company by the market price of the stock issued may result in recording acquired goodwill at more or less than its value determined directly.

25. A related argument is that the purchase method is improper accounting for a business combination in which a relatively large number of shares of stock is issued because it records the goodwill and fair values of only the acquired company. Critics of purchase accounting say that each group of stockholders of two publicly held and actively traded companies evaluates the other stock, and the exchange ratio for stock issued is often predicated on relative market values. The stockholders and management of each company evaluate the goodwill and fair values of the other. Purchase accounting is thus viewed as illogical because it records goodwill and values of only one side of the transaction. Those who support this view prefer that assets and liabilities of both companies be combined at existing recorded amounts, but if one side is to be stated at fair values, they believe that both sides should be recorded at fair values.

26. Criticism of the purchase method is directed not only to the theoretical and practical problems of measuring goodwill in combinations effected primarily by stock

but also to accounting after the combination for goodwill recorded by the purchase method. Present accounting for goodwill, which often has an indeterminate useful life, is cited as an example of lack of uniformity because selecting among alternative methods of accounting is discretionary.

Pooling of Interests Method

27. The more important arguments expressing the advantages and disadvantages of the pooling of interests method and some of the practical difficulties experienced in implementing it are summarized in paragraphs 28 to 41.

28. *Validity of the concept.* Those who support the pooling of interests method believe that a business combination effected by issuing common stock is different from a purchase in that no corporate assets are disbursed to stockholders and the net assets of the issuing corporation are enlarged by the net assets of the corporation whose stockholders accept common stock of the combined corporation. There is no newly invested capital nor have owners withdrawn assets from the group since the stock of a corporation is not one of its assets. Accordingly, the net assets of the constituents remain intact but combined; the stockholder groups remain intact but combined. Aggregate income is not changed since the total resources are not changed. Consequently, the historical costs and earnings of the separate corporations are appropriately combined. In a business combination effected by exchanging stock, groups of stockholders combine their resources, talents, and risks to form a new entity to carry on in combination the previous businesses and to continue their earnings streams. The sharing of risks by the constituent stockholder groups is an important element in a business combination effected by exchanging stock. By pooling equity interests, each group continues to maintain risk elements of its former investment and they mutually exchange risks and benefits.

29. A pooling of interests transaction is regarded as in substance an arrangement among stockholder groups. The fractional interests in the common enterprise are reallocated—risks are rearranged among the stockholder groups outside the corporate entity. A fundamental concept of entity accounting is that a corporation is separate and distinct from its stockholders. Elected managements represent the stockholders in bargaining to effect a combination, but the groups of stockholders usually decide whether the proposed terms are acceptable by voting to approve or disapprove a combination. Stockholders sometimes disapprove a combination proposed by management, and tender offers sometimes succeed despite the opposition of management.

30. Each stockholder group in a pooling of interests gives up its interests in assets formerly held but receives an interest in a portion of the assets formerly held in addition to an interest in the assets of the other. The clearest example of this type of combination is one in which both groups surrender their stock and receive in exchange stock of a new corporation. The fact that one of the corporations usually issues its stock in exchange for that of the other does not alter the substance of the transaction.

31. *Consistency with other concepts.* Proponents of pooling of interests accounting point out that the pooling concept was developed within the boundaries of the historical-cost system and is compatible with it. Accounting by the pooling of interests method for business combinations arranged through the issuance of common stock is based on existing accounting concepts and is not an occasion for revising historical costs. Both constituents usually have elements of appreciation and of goodwill which are recognized and offset, at least to some extent, in setting a ratio of exchange of stock. The bargaining which occurs usually reflects the relative earning capacities (measured by historical-cost accounts) of the constituents and frequently recognizes the relative market values of the two stocks, which in turn reflect earning capacity, goodwill, or other values. Accounting recognizes the bargaining by means of the new number of shares outstanding distributed in accordance with the bargained ratio, which has a direct effect on earnings per share after the combination.

32. *Usefulness of the concept.* Those who favor the pooling of interests method of accounting believe that the economic substance of a combination is best reflected by reporting operations up to the date of the exchange of stock based on the same historical-cost information used to develop the separate operating results of each constituent. Also, informative comparison with periods prior to the business combination is facilitated by maintaining historical costs as the basis of reporting combined operations subsequent to the combination.

33. *Application of the concept.* It has been observed that criteria for distinguishing

between a pooling and a purchase have eroded over the years and that present interpretations of criteria have led to abuse. However, most accountants who support the pooling concept believe that criteria can be redefined satisfactorily to eliminate abuses. It is their view that the pooling of interests method of accounting for business combinations is justifiable on conceptual grounds and is a useful technique and therefore should be retained.

34. Some proponents of pooling of interests accounting support a restriction on the difference in size of combining interests because a significant sharing of risk cannot occur if one combining interest is minor or because a meaningful mutual exchange does not occur if the combination involves a relatively small number of shares. Most, however, believe that there is no conceptual basis for a size restriction and that establishing a size restriction would seriously impair pooling of interests accounting.

35. *Defects attributed to pooling of interests method.* Those who oppose the pooling of interests method of accounting doubt that the method is supported by a concept. In their view it has become essentially a method of accounting for an acquisition of a company without recognizing the current costs of the assets, including goodwill, underlying the transaction. The concept of a pooling of interests was described in general terms in the past—for example, as a continuity of equity interests or as a combination of two or more interests of comparable size. The descriptions tend to be contradictory. For example, accountants do not agree on whether or not relative size is part of the pooling of interests concept. Attempts to define the concept in terms of broad criteria for applying the method have also been unsuccessful.

36. Indeed, many opponents of the pooling of interests method of accounting believe that effective criteria cannot be found. The concept of a uniting or fusing of stockholder groups on which pooling of interests accounting is based implies a broad application of the method because every combination effected by issuing stock rather than by disbursing cash or incurring debt is potentially a pooling of interests unless the combination significantly changes the relative equity interests. However, so broad an application without effective criteria results in applying the pooling of interests method to numerous business combinations which are clearly in economic substance the acquisition of one company by another.

37. Some critics point out that the method was first applied to combining interests of comparable size and that pronouncements on business combinations have never sanctioned applying pooling of interests accounting to all or almost all business combinations effected by exchanging stock. All pronouncements have indicated that a large disparity in the size of the combining interests is evidence that one corporation is acquiring another.

38. Other criteria restricting application of pooling of interests accounting, such as those prohibiting future disposals of stock received and providing for continuity of management, were added to the size restriction. Those criteria have, however, tended to strengthen the view that one corporation acquires another because they are unilateral, that is, they are applied only to the stockholders and management of the "acquired" company.

39. The most serious defect attributed to pooling of interests accounting by those who oppose it is that it does not accurately reflect the economic substance of the business combination transaction. They believe that the method ignores the bargaining which results in the combination by accounting only for the amounts previously shown in accounts of the combining companies. The acquiring corporation does not record assets and values which usually influence the final terms of the combination agreement with consequent effects on subsequent balance sheets and income statements. The combined earnings streams, which are said to continue after a pooling of interests, can continue unchanged only if the cost of the assets producing those earnings is identical for the acquiring corporation and the acquired company. That coincidence rarely occurs because the bargaining is based on current values and not past costs.

40. Pooling of interests accounting is also challenged because the amount of assets acquired less liabilities assumed is recorded without regard to the number of shares of stock issued. The result does not reflect the presumption that a corporation issues stock only for value received and, in general, the greater the number of shares issued, the larger the consideration to be recorded.

41. Traditional principles of accounting for acquisitions of assets encompass all business combinations because every combination is effected by distributing assets, incurring liabilities, issuing stock, or some blend of the three. Those who oppose the

pooling of interests method believe that a departure from the traditional principles is justified only if evidence shows that financial statements prepared according to other principles better reflect the economic significance of a combination. In their opinion, the characteristics of a business combination do not justify departing from traditional principles of accounting to accommodate the pooling of interests method.

OPINION

Applicability of Accounting Methods

42. The Board finds merit in both the purchase and pooling of interests methods of accounting for business combinations and accepts neither method to the exclusion of the other. The arguments in favor of the purchase method of accounting are more persuasive if cash or other assets are distributed or liabilities are incurred to effect a combination, but arguments in favor of the pooling of interests method of accounting are more persuasive if voting common stock is issued to effect a combination of common stock interests. Therefore, the Board concludes that some business combinations should be accounted for by the purchase method and other combinations should be accounted for by the pooling of interests method.

43. The Board also concludes that the two methods are not alternatives in accounting for the same business combination. A single method should be applied to an entire combination; the practice now known as part-purchase, part-pooling is not acceptable. The acquisition after the effective date of this Opinion of some or all of the stock held by minority stockholders of a subsidiary—whether acquired by the parent, the subsidiary itself, or another affiliate—should be accounted for by the purchase method rather than by the pooling of interests method.

44. The Board believes that accounting for business combinations will be improved significantly by specifying the circumstances in which each method should be applied and the procedures which should be followed in applying each method. The distinctive conditions which require pooling of interests accounting are described in paragraphs 45 to 48, and combinations involving all of those conditions should be accounted for as described in paragraphs 50 to 65. All other business combinations should be treated as the acquisition of one company by another and accounted for by the purchase method as described in paragraphs 66 to 96.

Conditions for Pooling of Interests Method

45. The pooling of interests method of accounting is intended to present as a single interest two or more common stockholder interests which were previously independent and the combined rights and risks represented by those interests. That method shows that stockholder groups neither withdraw nor invest assets but in effect exchange voting common stock in a ratio that determines their respective interests in the combined corporation. Some business combinations have those features. A business combination which meets *all* of the conditions specified and explained in paragraphs 46 to 48 should be accounted for by the pooling of interests method. The conditions are classified by (1) attributes of the combining companies, (2) manner of combining interests, and (3) absence of planned transactions.

46. *Combining companies.* Certain attributes of combining companies indicate that independent ownership interests are combined in their entirety to continue previously separate operations. Combining virtually all of existing common stock interests avoids combining only selected assets, operations, or ownership interests, any of which is more akin to disposing of and acquiring interests than to sharing risks and rights. It also avoids combining interests that are already related by substantial intercorporate investments.

The two conditions in this paragraph define essential attributes of combining companies.

a. Each of the combining companies is autonomous and has not been a subsidiary or division of another corporation within two years before the plan of combination is initiated.

A plan of combination is initiated on the earlier of (1) the date that the major terms of a plan, including the ratio of exchange of stock, are announced publicly or otherwise formally made known to the stockholders of any one of the combining companies or (2) the date that stockholders of a combining company are notified in writing of an exchange offer. Therefore, a plan of combination is often initiated even though consummation is subject to the approval of stockholders and others.

A new company incorporated within the preceding two years meets this condition unless the company is successor to a part of a company or to a company that is otherwise not autonomous for this condition. A wholly owned subsidiary company which distributes voting common stock of its parent corporation to effect the combination is also considered an autonomous company provided the parent corporation would have met all conditions in paragraphs 46 to 48 had the parent corporation issued its stock directly to effect the combination.

Divestiture of assets to comply with an order of a governmental authority or judicial body results in an exception to the terms of this condition. Either a subsidiary divested under an order or a new company which acquires assets disposed of under an order is therefore autonomous for this condition.

b. Each of the combining companies is independent of the other combining companies.

This condition means that at the dates the plan of combination is initiated and consummated the combining companies hold as intercorporate investments no more than 10 percent in total of the outstanding voting common stock of any combining company.[4] For the percentage computation, intercorporate investments exclude voting common stock that is acquired after the date the plan of combination is initiated in exchange for the voting common stock issued to effect the combination. Investments of 10 percent or less are explained in paragraph 47-b.

47. *Combining of interests.* The combining of existing voting common stock interests by the exchange of stock is the essence of a business combination accounted for by the pooling of interests method. The separate stockholder interests lose their identities and all share mutually in the combined risks and rights. Exchanges of common stock that alter relative voting rights, that result in preferential claims to distributions of profits or assets for some common stockholder groups, or that leave significant minority interests in combining companies are incompatible with the idea of mutual sharing. Similarly, acquisitions of common stock for assets or debt, reacquisitions of outstanding stock for the purpose of exchanging it in a business combination, and other transactions that reduce the common stock interests are contrary to the idea of combining existing stockholder interests. The seven conditions in this paragraph relate to the exchange to effect the combination.

a. The combination is effected in a single transaction or is completed in accordance with a specific plan within one year after the plan is initiated.

Altering the terms of exchange of stock constitutes initiation of a new plan of combination unless earlier exchanges of stock are adjusted to the new terms.[5]

A business combination completed in more than one year from the date the plan is initiated meets this condition if the delay is beyond the control of the combining companies because proceedings of a governmental authority or litigation prevent completing the combination.

b. A corporation offers and issues only common stock with rights identical to those of the majority of its outstanding voting common stock[6] in exchange for substantially all of the voting common stock interest of another company at the date the plan of combination is consummated.

The plan to issue voting common stock in exchange for voting common stock may include, within limits, provisions to distribute cash or other consideration for fractional shares, for shares held by dissenting stockholders, and the like but may not include a pro rata distribution of cash or other consideration.

Substantially all of the voting common stock means 90 percent or more for this condition. That is, after the date the plan of combination is initiated, one of the combining companies (issuing corporation) issues voting common stock in exchange for at least 90 percent of the voting common stock of another combining company that is outstanding at the date the combination is consummated. The number of shares exchanged therefore excludes those shares of the com-

[4] An exception for common stock held on October 31, 1970 is explained in paragraph 99.

[5] However, an adjustment after the effective date of this Opinion in the terms of exchange in a plan of combination initiated before and consummated after the effective date always constitutes initiation of a new plan. The one year specified in this condition is measured, therefore, from the date of adjustment of terms and all other conditions are evaluated for the new plan. (Paragraph 97 describes the application of this Opinion to a plan of combination initiated before the effective date of this Opinion and consummated later in accordance with the terms of exchange prevailing on the effective date.)

[6] A class of stock that has voting control of a corporation is the majority class.

bining company (1) acquired before and held by the issuing corporation and its subsidiaries at the date the plan of combination is initiated, regardless of the form of consideration,[7] (2) acquired by the issuing corporation and its subsidiaries after the date the plan of combination is initiated other than by issuing its own voting common stock, and (3) outstanding after the date the combination is consummated.

An investment in stock of the issuing corporation held by a combining company may prevent a combination from meeting this condition even though the investment of the combining company is not more than 10 percent of the outstanding stock of the issuing corporation (paragraph 46-b). An investment in stock of the issuing corporation by another combining company is the same in a mutual exchange as an investment by the issuing corporation in stock of the other combining company—the choice of issuing corporation is essentially a matter of convenience. An investment in stock of the issuing corporation must be expressed as an equivalent number of shares of the investor combining company because the measure of percent of shares exchanged is in terms of shares of stock of the investor company. An investment in 10 percent or less of the outstanding voting common stock of the issuing corporation affects the measure of percent of shares exchanged in the combination as follows:

The number of shares of voting common stock of the issuing corporation held by the investor combining company at the date the plan is initiated plus shares it acquired after that date are restated as an equivalent number of shares of voting common stock of the investor combining company based on the ratio of exchange of stock in the combination.

The equivalent number of shares is deducted from the number of shares of voting common stock of the investor combining company exchanged for voting common stock of the issuing corporation as part of the plan of combination.

The reduced number of shares is considered the number exchanged and is compared with 90 percent of the outstanding voting common stock of the investor combining company at the date the plan is consummated to determine whether the terms of condition 47-b are met.

Since the number of shares of voting common stock exchange is reduced for an intercorporate investment in voting common stock of the issuing corporation, the terms of condition 47-b may not be met even though 90 percent or more of the outstanding common stock of a combining company is exchanged to effect a combination.

A combination of more than two companies is evaluated essentially the same as a combination of two companies. The percent of voting common stock exchanged is measured separately for each combining company, and condition 47-b is met if 90 percent or more of the voting common stock of each of the several combining companies is exchanged for voting common stock of the issuing corporation. The number of shares exchanged for stock of the issuing corporation includes only shares exchanged by stockholders other than the several combining companies themselves. Thus, intercorporate investments in combining companies are included in the number of shares of stock outstanding but are excluded from the number of shares of stock exchanged to effect the combination.

A new corporation formed to issue its stock to effect the combination of two or more companies meets condition 47-b if (1) the number of shares of each company exchanged to effect the combination is not less than 90 percent of its voting common stock outstanding at the date the combination is consummated and (2) condition 47-b would have been met had any one of the combining companies issued its stock to effect the combination on essentially the same basis.

Condition 47-b relates to issuing common stock for the common stock interests in another company. Hence, a corporation issuing stock to effect the combination may assume the debt securities of the other company or may exchange substantially identical securities or voting common stock for other outstanding equity and debt securities of the other combining company. An issuing corporation may also distribute cash to holders of debt and equity securities that either are callable or redeemable and may retire those securities. However, the issuing corporation may exchange only voting common stock for outstanding equity and debt securities of the other combining company that have been issued in exchange for voting common stock of that company during a period beginning two years preceding the date the combination is initiated.

[7] An exception for common stock held on October 31, 1970 is explained in paragraph 99.

A transfer of the net assets of a combining company to effect a business combination satisfies condition 47-b provided all net assets of the company at the date the plan is consummated are transferred in exchange for stock of the issuing corporation. However, the combining company may retain temporarily cash, receivables, or marketable securities to settle liabilities, contingencies, or items in dispute if the plan provides that the assets remaining after settlement are to be transferred to the corporation issuing the stock to effect the combination. Only voting common stock may be issued to effect the combination unless both voting common stock and other stock of the other combining company are outstanding at the date the plan is consummated. The combination may then be effected by issuing all voting common stock or by issuing voting common and other stock in the same proportions as the outstanding voting common and other stock of the other combining company. An investment in 10 percent or less of the outstanding voting common stock of a combining company held by another combining company requires special computations to evaluate condition 47-b. The computations and comparisons are in terms of the voting common stock of the issuing corporation and involve:

Stock issued for common stock interest. The total number of shares of voting common stock issued for all of the assets[8] is divided between those applicable to outstanding voting common stock and those applicable to other outstanding stock, if any, of the combining company which transfers assets (transferor company).

Reduction for intercorporate investments. The number of issued shares of voting common stock applicable to the voting common stock interests of the transferor combining company is reduced by the sum of (1) the number of shares of voting common stock of the issuing corporation held by the transferor combining company at the date the plan of combination is initiated plus shares it acquired after that date and (2) the number of shares of voting common stock of the transferor combining company held by the issuing corporation at the date the plan of combination is initiated plus shares it acquired after that date. The shares of the transferor combining company are restated as the equivalent number of shares of voting common stock of the issuing corporation for this purpose. Restatement is based on the ratio of the number of shares of voting common stock of the transferor combining company which are outstanding at the date the plan is consummated to the number of issued shares of voting common stock applicable to the voting common stock interests.

Comparison with 90 percent. The reduced number of shares of stock issued is compared with 90 percent of the issued number of shares of voting common stock applicable to voting common stock interests to determine if the transfer of assets meets the terms of condition 47-b.

c. None of the combining companies changes the equity interest of the voting common stock in contemplation of effecting the combination either within two years before the plan of combination is initiated or between the dates the combination is initiated and consummated; changes in contemplation of effecting the combination may include distributions to stockholders and additional issuances, exchanges, and retirements of securities.

Distributions to stockholders which are no greater than normal dividends are not changes for this condition. Normality of dividends is determined in relation to earnings during the period and to the previous dividend policy and record. Dividend distributions on stock of a combining company that are equivalent to normal dividends on the stock to be issued in exchange in the combination are considered normal for this condition.

d. Each of the combining companies reacquires shares of voting common stock only for purposes other than business combinations, and no company reacquires more than a normal number of shares between the dates the plan of combination is initiated and consummated.

Treasury stock acquired for purposes other than business combinations includes shares for stock option and compensation plans and other recurring distributions provided a systematic pattern of reacquisitions is established at least two years before the plan of combination is initiated. A systematic pattern of reacquisitions may be established for less than two years if it coincides with the adoption of a new stock option or compensation plan. The normal number

[8] Including (for this computation) stock of the issuing corporation held by the transferor combining company.

of shares of voting common stock reacquired is determined by the pattern of reacquisitions of stock before the plan of combination is initiated.

Acquisitions by other combining companies of voting common stock of the issuing corporation after the date the plan of combination is initiated are essentially the same as if the issuing corporation reacquired its own common stock.

e. The ratio of the interest of an individual common stockholder to those of other common stockholders in a combining company remains the same as a result of the exchange of stock to effect the combination.

This condition means that each individual common stockholder who exchanges his stock receives a voting common stock interest exactly in proportion to his relative voting common stock interest before the combination is effected. Thus no common stockholder is denied or surrenders his potential share of a voting common stock interest in a combined corporation.

f. The voting rights to which the common stock ownership interests in the resulting combined corporation are entitled are exercisable by the stockholders; the stockholders are neither deprived of nor restricted in exercising those rights for a period.

This condition is not met, for example, if shares of common stock issued to effect the combination are transferred to a voting trust.

g. The combination is resolved at the date the plan is consummated and no provisions of the plan relating to the issue of securities or other consideration are pending.

This condition means that (1) the combined corporation does not agree to contingently issue additional shares of stock or distribute other consideration at a later date to the former stockholders of a combining company or (2) the combined corporation does not issue or distribute to an escrow agent common stock or other consideration which is to be either transferred to common stockholders or returned to the corporation at the time the contingency is resolved.

An agreement may provide, however, that the number of shares of common stock issued to effect the combination may be revised for the later settlement of a contingency at a different amount than that recorded by a combining company.

48. *Absence of planned transactions.* Some transactions after a combination is consummated are inconsistent with the combining of entire existing interests of common stockholders. Including those transactions in the negotiations and terms of the combination, either explicitly or by intent, counteracts the effect of combining stockholder interests. The three conditions in this paragraph relate to certain future transactions.

a. The combined corporation does not agree directly or indirectly to retire or reacquire all or part of the common stock issued to effect the combination.

b. The combined corporation does not enter into other financial arrangements for the benefit of the former stockholders of a combining company, such as a guaranty of loans secured by stock issued in the combination, which in effect negates the exchange of equity securities.

c. The combined corporation does not intend or plan to dispose of a significant part of the assets of the combining companies within two years after the combination other than disposals in the ordinary course of business of the formerly separate companies and to eliminate duplicate facilities or excess capacity.

Subsidiary Corporation

49. Dissolution of a combining company is not a condition for applying the pooling of interests method of accounting for a business combination. One or more combining companies may be subsidiaries of the issuing corporation after the combination is consummated if the other conditions are met.

Application of Pooling of Interests Method

50. A business combination which meets all of the conditions in paragraphs 45 to 48 should be accounted for by the pooling of interests method. Appropriate procedures are described in paragraphs 51 to 65.

Assets and Liabilities Combined

51. The recorded assets and liabilities of the separate companies generally become the recorded assets and liabilities of the combined corporation. The combined corporation therefore recognizes those assets and liabilities recorded in conformity with generally accepted accounting principles by the separate companies at the date the combination is consummated.

52. The combined corporation records the historical-cost based amounts of the assets and liabilities of the separate companies because the existing basis of accounting continues. However, the separate companies may have recorded assets and liabilities under differing methods of accounting and the amounts may be adjusted to the same basis of accounting if the change would otherwise have been appropriate for the separate company. A change in accounting method to conform the individual methods should be applied retroactively, and financial statements presented for prior periods should be restated.

Stockholders' Equity Combined

53. The stockholders' equities of the separate companies are also combined as a part of the pooling of interests method of accounting. The combined corporation records as capital the capital stock and capital in excess of par or stated value of outstanding stock of the separate companies. Similarly, retained earnings or deficits of the separate companies are combined and recognized as retained earnings of the combined corporation (paragraph 56). The amount of outstanding shares of stock of the combined corporation at par or stated value may exceed the total amount of capital stock of the separate combining companies; the excess should be deducted first from the combined other contributed capital and then from the combined retained earnings. The combined retained earnings could be misleading if shortly before or as a part of the combination transaction one or more of the combining companies adjusted the elements of stockholders' equity to eliminate a deficit; therefore, the elements of equity before the adjustment should be combined.

54. A corporation which effects a combination accounted for by the pooling of interests method by distributing stock previously acquired as treasury stock (paragraph 47-d) should first account for those shares of stock as though retired. The issuance of the shares for the common stock interests of the combining company is then accounted for the same as the issuance of previously unissued shares.

55. Accounting for common stock of one of the combining companies which is held by another combining company at the date a combination is consummated depends on whether the stock is the same as that which is issued to effect the combination or is the same as the stock which is exchanged in the combination. An investment of a combining company in the common stock of the issuing corporation is in effect returned to the resulting combined corporation in the combination. The combined corporation should account for the investment as treasury stock. In contrast, an investment in the common stock of other combining companies (not the one issuing stock in the combination) is an investment in stock that is exchanged in the combination for the common stock issued. The stock in that type of intercorporate investment is in effect eliminated in the combination. The combined corporation should account for that investment as stock retired as part of the combination.

Reporting Combined Operations

56. A corporation which applies the pooling of interests method of accounting to a combination should report results of operations for the period in which the combination occurs as though the companies had been combined as of the beginning of the period. Results of operations for that period thus comprise those of the separate companies combined from the beginning of the period to the date the combination is consummated and those of the combined operations from that date to the end of the period. Eliminating the effects of intercompany transactions from operations before the date of combination reports operations before and after the date of combination on substantially the same basis. The effects of intercompany transactions on current assets, current liabilities, revenue, and cost of sales for periods presented and on retained earnings at the beginning of the periods presented should be eliminated to the extent possible. The nature of and effects on earnings per share of nonrecurring intercompany transactions involving long-term assets and liabilities need not be eliminated but should be disclosed. A combined corporation should disclose in notes to financial statements the revenue, extraordinary items, and net income of each of the separate companies from the beginning of the period to the date the combination is consummated (paragraph 64-d). The information relating to the separate companies may be as of the end of the interim period nearest the date that the combination is consummated.

57. Similarly, balance sheets and other financial information of the separate companies as of the beginning of the period should be presented as though the companies had been combined at that date. Financial statements and financial information of the separate companies presented for prior

years should also be restated on a combined basis to furnish comparative information. All restated financial statements and financial summaries should indicate clearly that financial data of the previously separate companies are combined.

Expenses Related to Combination

58. The pooling of interests method records neither the acquiring of assets nor the obtaining of capital. Therefore, costs incurred to effect a combination accounted for by that method and to integrate the continuing operations are expenses of the combined corporation rather than additions to assets or direct reductions of stockholders' equity. Accordingly, all expenses related to effecting a business combination accounted for by the pooling of interests method should be deducted in determining the net income of the resulting combined corporation for the period in which the expenses are incurred. Those expenses include, for example, registration fees, costs of furnishing information to stockholders, fees of finders and consultants, salaries and other expenses related to services of employees, and costs and losses of combining operations of the previously separate companies and instituting efficiencies.

Disposition of Assets After Combination

59. A combined corporation may dispose of those assets of the separate companies which are duplicate facilities or excess capacity in the combined operations. Losses or estimated losses on disposal of specifically identified duplicate or excess facilities should be deducted in determining the net income of the resulting combined corporation. However, a loss estimated and recorded while a facility remains in service should not include the portion of the cost that is properly allocable to anticipated future service of the facility.

60. Profit or loss on other dispositions of assets of the previously separate companies may require special disclosure unless the disposals are part of customary business activities of the combined corporation. Specific treatment of a profit or loss on those dispositions is warranted because the pooling of interests method of accounting would have been inappropriate (paragraph 48-c) if the combined corporation were committed or planned to dispose of a significant part of the assets of one of the combining companies. The Board concludes that a combined corporation should disclose separately a profit or loss resulting from the disposal of a significant part of the assets or a separable segment of the previously separate companies, provided

> the profit or loss is material in relation to the net income of the combined corporation, and
>
> the disposition is within two years after the combination is consummated.

The disclosed profit or loss, less applicable income tax effect, should be classified as an extraordinary item.

Date of Recording Combination

61. A business combination accounted for by the pooling of interests method should be recorded as of the date the combination is consummated. Therefore, even though a business combination is consummated before one or more of the combining companies first issues its financial statements as of an earlier date, the financial statements issued should be those of the combining company and not those of the resulting combined corporation. A combining company should, however, disclose as supplemental information, in notes to financial statements or otherwise, the substance of a combination consummated before financial statements are issued and the effects of the combination on reported financial position and results of operations (paragraph 65). Comparative financial statements presented in reports of the resulting combined corporation after a combination is consummated should combine earlier financial statements of the separate companies.

62. A corporation may be reasonably assured that a business combination which has been initiated but not consummated as of the date of financial statements will meet the conditions requiring the pooling of interests method of accounting. The corporation should record as an investment common stock of the other combining company acquired before the statement date. Common stock acquired by disbursing cash or other assets or by incurring liabilities should be recorded at cost. Stock acquired in exchange for common stock of the issuing corporation should, however, be recorded at the proportionate share of underlying net assets at the date acquired as recorded by the other company. Until the pooling of interests method of accounting for the combination is known to be appropriate, the investment and net income of the investor corporation should include the proportionate share of earnings or losses of the other company after the date of acquisition of the stock. The investor corporation

should also disclose results of operations for all prior periods presented as well as the entire current period as they will be reported if the combination is later accounted for by the pooling of interests method. After the combination is consummated and the applicable method of accounting is known, financial statements issued previously should be restated as necessary to include the other combining company.

Disclosure of a Combination

63. A combined corporation should disclose in its financial statements that a combination which is accounted for by the pooling of interest method has occurred during the period. The basis of current presentation and restatements of prior periods may be disclosed in the financial statements by captions or by references to notes.

64. Notes to financial statements of a combined corporation should disclose the following for the period in which a business combination occurs and is accounted for by the pooling of interests method.

a. Name and brief description of the companies combined, except a corporation whose name is carried forward to the combined corporation.

b. Method of accounting for the combination—that is, by the pooling of interests method.

c. Description and number of shares of stock issued in the business combination.

d. Details of the results of operations of the previously separate companies for the period before the combination is consummated that are included in the current combined net income (paragraph 56). The details should include revenue, extraordinary items, net income, other changes in stockholders' equity, and amount of and manner of accounting for intercompany transactions.

e. Descriptions of the nature of adjustments of net assets of the combining companies to adopt the same accounting practices and of the effects of the changes on net income reported previously by the separate companies and now presented in comparative financial statements (paragraph 52).

f. Details of an increase or decrease in retained earnings from changing the fiscal year of a combining company. The details should include at least revenue, expenses, extraordinary items, net income, and other changes in stockholders' equity for the period excluded from the reported results of operations.

g. Reconciliations of amounts of revenue and earnings previously reported by the corporation that issues the stock to effect the combination with the combined amounts currently presented in financial statements and summaries. A new corporation formed to effect a combination may instead disclose the earnings of the separate companies which comprise combined earnings for prior periods.

The information disclosed in notes to financial statements should also be furnished on a pro forma basis in information on a proposed business combination which is given to stockholders of combining companies.

65. Notes to the financial statements should disclose details of the effects of a business combination consummated before the financial statements are issued but which is either incomplete as of the date of the financial statements or initiated after that date (paragraph 61). The details should include revenue, net income, earnings per share, and the effects of anticipated changes in accounting methods as if the combination had been consummated at the date of the financial statements (paragraph 52).

Application of Purchase Method

Principles of Historical-Cost Accounting

66. Accounting for a business combination by the purchase method follows principles normally applicable under historical-cost accounting to recording acquisitions of assets and issuances of stock and to accounting for assets and liabilities after acquisition.

67. *Acquiring assets.* The general principles to apply the historical-cost basis of accounting to an acquisition of an asset depend on the nature of the transaction:

a. An asset acquired by exchanging cash or other assets is recorded at cost—that is, at the amount of cash disbursed or the fair value of other assets distributed.

b. An asset acquired by incurring liabilities is recorded at cost—that is, at the present value of the amounts to be paid.

c. An asset acquired by issuing shares of stock of the acquiring corporation is recorded at the fair value of the asset[9]—that is, shares of stock issued are recorded at the fair value of the consideration received for the stock.

The general principles must be supplemented to apply them in certain transactions. For example, the fair value of an asset received for stock issued may not be reliably determinable, or the fair value of an asset acquired in an exchange may be more reliably determinable than the fair value of a noncash asset given up. Restraints on measurement have led to the practical rule that assets acquired for other than cash, including shares of stock issued, should be stated at "cost" when they are acquired and "cost may be determined either by the fair value of the consideration given or by the fair value of the property acquired, whichever is the more clearly evident."[10] "Cost" in accounting often means the amount at which an entity records an asset at the date it is acquired whatever its manner of acquisition, and that "cost" forms the basis for historical-cost accounting.

68. *Allocating cost.* Acquiring assets in groups requires not only ascertaining the cost of the assets as a group but also allocating the cost to the individual assets which comprise the group. The cost of a group is determined by the principles described in paragraph 67. A portion of the total cost is then assigned to each individual asset acquired on the basis of its fair value. A difference between the sum of the assigned costs of the tangible and identifiable intangible assets acquired less liabilities assumed and the cost of the group is evidence of unspecified intangible values.

69. *Accounting after acquisition.* The nature of an asset and not the manner of its acquisition determines an acquirer's subsequent accounting for the cost of that asset. The basis for measuring the cost of an asset—whether amount of cash paid, fair value of an asset received or given up, amount of a liability incurred, or fair value of stock issued—has no effect on the subsequent accounting for that cost, which is retained as an asset, depreciated, amortized, or otherwise matched with revenue.

Acquiring Corporation

70. A corporation which distributes cash or other assets or incurs liabilities to obtain the assets or stock of another company is clearly the acquirer. The identities of the acquirer and the acquired company are usually evident in a business combination effected by the issue of stock. The acquiring corporation normally issues the stock and commonly is the larger company. The acquired company may, however, survive as the corporate entity, and the nature of the negotiations sometimes clearly indicates that a smaller corporation acquires a larger company. The Board concludes that presumptive evidence of the acquiring corporation in combinations effected by an exchange of stock is obtained by identifying the former common stockholder interests of a combining company which either retain or receive the larger portion of the voting rights in the combined corporation. That corporation should be treated as the acquirer unless other evidence clearly indicates that another corporation is the acquirer. For example, a substantial investment of one company in common stock of another before the combination may be evidence that the investor is the acquiring corporation.

71. If a new corporation is formed to issue stock to effect a business combination to be accounted for by the purchase method, one of the existing combining companies should be considered the acquirer on the basis of the evidence available.

Determining Cost of an Acquired Company

72. The same accounting principles apply to determining the cost of assets acquired individually, those acquired in a group, and those acquired in a business combination. A cash payment by a corporation measures the cost of acquired assets less liabilities assumed. Similarly, the fair values of other assets distributed, such as marketable securities or properties, and the fair value of liabilities incurred by an acquiring corporation measure the cost of an acquired company. The present value of a debt security represents the fair value of the liability, and a premium or discount should be recorded for a debt security issued with an interest rate fixed materially above or below the effective rate or current yield for an otherwise comparable security.

73. The distinctive attributes of preferred stocks make some issues similar to a debt security while others possess common stock characteristics, with many gradations between the extremes. Determining cost of an acquired company may be affected by those characteristics. For example, the fair value of a nonvoting, nonconvertible preferred stock which lacks characteristics of

[9] An asset acquired may be an entire entity which may have intangible assets, including goodwill.

[10] ARB No. 24; the substance was retained in slightly different words in Chapter 5 of ARB No. 43 and ARB No. 48.

common stock may be determined by comparing the specified dividend and redemption terms with comparable securities and by assessing market factors. Thus although the principle of recording the fair value of consideration received for stock issued applies to all equity securities, senior as well as common stock, the cost of a company acquired by issuing senior equity securities may be determined in practice on the same basis as for debt securities.

74. The fair value of securities traded in the market is normally more clearly evident than the fair value of an acquired company (paragraph 67). Thus, the quoted market price of an equity security issued to effect a business combination may usually be used to approximate the fair value of an acquired company after recognizing possible effects of price fluctuations, quantities traded, issue costs, and the like (paragraph 23). The market price for a reasonable period before and after the date the terms of the acquisition are agreed to and announced should be considered in determining the fair value of securities issued.

75. If the quoted market price is not the fair value of stock, either preferred or common, the consideration received should be estimated even though measuring directly the fair values of assets received is difficult. Both the consideration received, including goodwill, and the extent of the adjustment of the quoted market price of the stock issued should be weighed to determine the amount to be recorded. All aspects of the acquisition, including the negotiations, should be studied, and independent appraisals may be used as an aid in determining the fair value of securities issued. Consideration other than stock distributed to effect an acquisition may provide evidence of the total fair value received.

76. *Cost of acquisition.* The cost of a company acquired in a business combination accounted for by the purchase method includes the direct costs of acquisition. Costs of registering and issuing equity securities are a reduction of the otherwise determinable fair value of the securities. However, indirect and general expenses related to acquisitions are deducted as incurred in determining net income.

Contingent Consideration

77. A business combination agreement may provide for the issuance of additional shares of a security or the transfer of cash or other consideration contingent on specified events or transactions in the future. Some agreements provide that a portion of the consideration be placed in escrow to be distributed or to be returned to the transferor when specified events occur. Either debt or equity securities may be placed in escrow, and amounts equal to interest or dividends on the securities during the contingency period may be paid to the escrow agent or to the potential security holder.

78. The Board concludes that cash and other assets distributed and securities issued unconditionally and amounts of contingent consideration which are determinable at the date of acquisition should be included in determining the cost of an acquired company and recorded at that date. Consideration which is issued or issuable at the expiration of the contingency period or which is held in escrow pending the outcome of the contingency should be disclosed but not recorded as a liability or shown as outstanding securities unless the outcome of the contingency is determinable beyond reasonable doubt.

79. Contingent consideration should usually be recorded when the contingency is resolved and consideration is issued or becomes issuable. In general, the issue of additional securities or distribution of other consideration at resolution of contingencies based on earnings should result in an additional element of cost of an acquired company. In contrast, the issue of additional securities or distribution of other consideration at resolution of contingencies based on security prices should not change the recorded cost of an acquired company.

80. *Contingency based on earnings.* Additional consideration may be contingent on maintaining or achieving specified earnings levels in future periods. When the contingency is resolved and additional consideration is distributable, the acquiring corporation should record the current fair value of the consideration issued or issuable as additional cost of the acquired company. The additional costs of affected assets, usually goodwill, should be amortized over the remaining life of the asset.

81. *Contingency based on security prices.* Additional consideration may be contingent on the market price of a specified security issued to effect a business combination. Unless the price of the security at least equals the specified amount on a specified date or dates, the acquiring corporation is required to issue additional equity or debt securities or transfer cash or other assets sufficient to make the current value of the total consideration equal to the specified amount. The securities issued uncondi-

tionally at the date the combination is consummated should be recorded at that date at the specified amount.

82. The cost of an acquired company recorded at the date of acquisition represents the entire payment, including contingent consideration. Therefore, the issuance of additional securities or distribution of other consideration does not affect the cost of the acquired company, regardless of whether the amount specified is a security price to be maintained or a higher security price to be achieved. On a later date when the contingency is resolved and additional consideration is distributable, the acquiring corporation should record the current fair value of the additional consideration issued or issuable. However, the amount previously recorded for securities issued at the date of acquisition should simultaneously be reduced to the lower current value of those securities. Reducing the value of debt securities previously issued to their later fair value results in recording a discount on debt securities. The discount should be amortized from the date the additional securities are issued.

83. Accounting for contingent consideration based on conditions other than those described should be inferred from the procedures outlined. For example, if the consideration contingently issuable depends on both future earnings and future security prices, additional cost of the acquired company should be recorded for the additional consideration contingent on earnings, and previously recorded consideration should be reduced to current value of the consideration contingent on security prices. Similarly, if the consideration contingently issuable depends on later settlement of a contingency, an increase in the cost of acquired assets, if any, should be amortized over the remaining life of the assets.

84. *Interest or dividends during contingency period.* Amounts paid to an escrow agent representing interest and dividends on securities held in escrow should be accounted for according to the accounting for the securities. That is, until the disposition of the securities in escrow is resolved, payments to the escrow agent should not be recorded as interest expense or dividend distributions. An amount equal to interest and dividends later distributed by the escrow agent to the former stockholders should be added to the cost of the acquired assets at the date distributed and amortized over the remaining life of the assets.

85. *Tax effect of imputed interest.* A tax reduction resulting from imputed interest on contingently issuable stock reduces the fair value recorded for contingent consideration based on earnings and increases additional capital recorded for contingent consideration based on security prices.

86. *Compensation in contingent agreements.* The substance of some agreements for contingent consideration is to provide compensation for services or use of property or profit sharing, and the additional consideration given should be accounted for as expenses of the appropriate periods.

Recording Assets Acquired and Liabilities Assumed

87. An acquiring corporation should allocate the cost of an acquired company to the assets acquired and liabilities assumed. Allocation should follow the principles described in paragraph 68.

> First, all identifiable assets acquired, either individually or by type, and liabilities assumed in a business combination, whether or not shown in the financial statements of the acquired company, should be assigned a portion of the cost of the acquired company, normally equal to their fair values at date of acquisition.
>
> Second, the excess of the cost of the acquired company over the sum of the amounts assigned to identifiable assets acquired less liabilities assumed should be recorded as goodwill. The sum of the market or appraisal values of identifiable assets acquired less liabilities assumed may sometimes exceed the cost of the acquired company. If so, the values otherwise assignable to noncurrent assets acquired (except long-term investments in marketable securities) should be reduced by a proportionate part of the excess to determine the assigned values. A deferred credit for an excess of assigned value of identifiable assets over cost of an acquired company (sometimes called "negative goodwill") should not be recorded unless those assets are reduced to zero value.

Independent appraisals may be used as an aid in determining the fair values of some assets and liabilities. Subsequent sales of assets may also provide evidence of values. The effect of taxes may be a factor in assigning amounts to identifiable assets and liabilities (paragraph 89).

88. General guides for assigning amounts to the individual assets acquired and liabilities assumed, except goodwill, are:

a. Marketable securities at current net realizable values.

b. Receivables at present values of amounts to be received determined at appropriate current interest rates, less allowances for uncollectibility and collection costs, if necessary.

c. Inventories:

(1) Finished goods and merchandise at estimated selling prices less the sum of (a) costs of disposal and (b) a reasonable profit allowance for the selling effort of the acquiring corporation.

(2) Work in process at estimated selling prices of finished goods less the sum of (a) costs to complete, (b) costs of disposal, and (c) a reasonable profit allowance for the completing and selling effort of the acquiring corporation based on profit for similar finished goods.

(3) Raw materials at current replacement costs.

d. Plant and equipment: (1) to be used, at current replacement costs for similar capacity[11] unless the expected future use of the assets indicates a lower value to the acquirer, (2) to be sold or held for later sale rather than used, at current net realizable value, and (3) to be used temporarily, at current net realizable value recognizing future depreciation for the expected period of use.

e. Intangible assets which can be identified and named, including contracts, patents, franchises, customer and supplier lists, and favorable leases, at appraised values.[12]

f. Other assets, including land, natural resources, and nonmarketable securities, at appraised values.

g. Accounts and notes payable, long-term debt, and other claims payable at present values of amounts to be paid determined at appropriate current interest rates.

h. Liabilities and accruals—for example, accruals for pension cost,[13] warranties, vacation pay, deferred compensation—at present values of amounts to be paid determined at appropriate current interest rates.

i. Other liabilities and commitments, including unfavorable leases, contracts, and commitments and plant closing expense incident to the acquisition, at present values of amounts to be paid determined at appropriate current interest rates.

An acquiring corporation should record periodically as a part of income the accrual of interest on assets and liabilities recorded at acquisition date at the discounted values of amounts to be received or paid. An acquiring corporation should not record as a separate asset the goodwill previously recorded by an acquired company and should not record deferred income taxes recorded by an acquired company before its acquisition. An acquiring corporation should reduce the acquired goodwill retroactively for the realized tax benefits of loss carry-forwards of an acquired company not previously recorded by the acquiring corporation.

89. The market or appraisal values of specific assets and liabilities determined in paragraph 88 may differ from the income tax bases of those items. Estimated future tax effects of differences between the tax bases and amounts otherwise appropriate to assign to an asset or a liability are one of the variables in estimating fair value. Amounts assigned to identifiable assets and liabilities should, for example, recognize that the fair value of an asset to an acquirer is less than its market or appraisal value if all or a portion of the market or appraisal value is not deductible for income taxes. The impact of tax effects on amounts assigned to individual assets and liabilities depends on numerous factors, including imminence or delay of realization of the asset value and the possible timing of tax consequences. Since differences between amounts assigned and tax bases are not timing differences (APB Opinion No. 11, *Accounting for Income Taxes*, paragraph 13), the acquiring corporation should not record deferred tax accounts at the date of acquisition.

[11] Replacement cost may be determined directly if a used asset market exists for the assets acquired. Otherwise, the replacement cost should be approximated from replacement cost new less estimated accumulated depreciation.

[12] Fair values should be ascribed to specific assets; identifiable assets should not be included in goodwill.

[13] An accrual for pension cost should be the greater of (1) accrued pension cost computed in conformity with the accounting policies of the acquiring corporation for one or more of its pension plans or (2) the excess, if any, of the actuarially computed value of vested benefits over the amount of the pension fund.

Amortization of Goodwill

90. Goodwill recorded in a business combination accounted for by the purchase method should be amortized in accordance with the provisions in paragraphs 27 to 31 of APB Opinion No. 17 *Intangible Assets.*

Excess of Acquired Net Assets Over Cost

91. The value assigned to net assets acquired should not exceed the cost of an acquired company because the general presumption in historical-cost based accounting is that net assets acquired should be recorded at not more than cost. The total market or appraisal values of identifiable assets acquired less liabilities assumed in a few business combinations may exceed the cost of the acquired company. An excess over cost should be allocated to reduce proportionately the values assigned to noncurrent assets (except long-term investments in marketable securities) in determining their fair values (paragraph 87). If the allocation reduces the noncurrent assets to zero value, the remainder of the excess over cost should be classified as a deferred credit and should be amortized systematically to income over the period estimated to be benefited but not in excess of forty years. The method and period of amortization should be disclosed.

92. No part of the excess of acquired net assets over cost should be added directly to stockholders' equity at the date of acquisition.

Acquisition Date

93. The Board believes that the date of acquisition of a company should ordinarily be the date assets are received and other assets are given or securities are issued. However, the parties may for convenience designate as the effective date the end of an accounting period between the dates a business combination is initiated and consummated. The designated date should ordinarily be the date of acquisition for accounting purposes if a written agreement provides that effective control of the acquired company is transferred to the acquiring corporation on that date without restrictions except those required to protect the stockholders or other owners of the acquired company—for example, restrictions on significant changes in the operations, permission to pay dividends equal to those regularly paid before the effective date, and the like. Designating an effective date other than the date assets or securities are transferred requires adjusting the cost of an acquired company and net income otherwise reported to compensate for recognizing income before consideration is transferred. The cost of an acquired company and net income should therefore be reduced by imputed interest at an appropriate current rate on assets given, liabilities incurred, or preferred stock distributed as of the transfer date to acquire the company.

94. The cost of an acquired company and the values assigned to assets acquired and liabilities assumed should be determined as of the date of acquisition. The statement of income of an acquiring corporation for the period in which a business combination occurs should include income of the acquired company after the date of acquisition by including the revenue and expenses of the acquired operations based on the cost to the acquiring corporation.

Disclosure in Financial Statements

95. Notes to the financial statements of an acquiring corporation should disclose the following for the period in which a business combination occurs and is accounted for by the purchase method.

a. Name and a brief description of the acquired company.

b. Method of accounting for the combination—that is, by the purchase method.

c. Period for which results of operations of the acquired company are included in the income statement of the acquiring corporation.

d. Cost of the acquired company and, if applicable, the number of shares of stock issued or issuable and the amount assigned to the issued and issuable shares.

e. Description of the plan for amortization of acquired goodwill, the amortization method, and period (APB Opinion No. 17, paragraphs 27 to 31).

f. Contingent payments, options, or commitments specified in the acquisition agreement and their proposed accounting treatment.

Information relating to several relatively minor acquisitions may be combined for disclosure.

96. Notes to the financial statements of the acquiring corporation for the period in which a business combination occurs and is accounted for by the purchase method should include as supplemental information the following results of operations on a pro forma basis:

a. Results of operations for the current period as though the companies had combined at the beginning of the period, unless the acquisition was at or near the beginning of the period.

b. Results of operations for the immediately preceding period as though the companies had combined at the beginning of that period if comparative financial statements are presented.

The supplemental pro forma information should as a minimum show revenue, income before extraordinary items, net income, and earnings per share. To present pro forma information, income taxes, interest expense, preferred stock dividends, depreciation and amortization of assets, including goodwill, should be adjusted to their accounting bases recognized in recording the combination. Pro forma presentation of results of operations of periods prior to the combination transaction should be limited to the immediately preceding period.

EFFECTIVE DATE

97. The provisions of this Opinion shall be effective to account for business combinations initiated[14] after October 31, 1970. Business combinations initiated before November 1, 1970 and consummated on or after that date under the terms prevailing on October 31, 1970 (paragraph 47-a) may be accounted for in accordance with this Opinion or the applicable previous pronouncements of the Board and its predecessor committee.

98. The provisions of this Opinion should not be applied retroactively for business combinations consummated before November 1, 1970.

99. If a corporation holds as an investment on October 31, 1970 a minority interest in or exactly 50 percent of the common stock of another company and the corporation initiates after October 31, 1970 a plan of combination with that company, the resulting business combination may be accounted for by the pooling of interests method provided

the combination is completed within five years after October 31, 1970 and

the combination meets all conditions specified in paragraphs 45 to 48, except that

(i) the minority interest in the voting common stock of the combining company held on October 31, 1970 may exceed 10 percent of the outstanding voting common stock of the combining company (paragraph 46-b), and

(ii) the corporation which effects the combination issues voting common stock for at least 90 percent of the outstanding voting common stock interest, as described in paragraph 47-b, of the other combining company not already held on October 31, 1970 (rather than 90 percent of all of the common stock interest of the combining company).

The investment in common stock held on October 31, 1970 should not be accounted for as treasury stock or retired stock at the date of the combination. Instead, the excess of cost over the investor corporation's proportionate equity in the net assets of the combining company at or near the date the stock investment was acquired should be allocated to identifiable assets of the combining company at the date the combination is consummated on the basis of the fair values of those assets at the combination date. The unallocated portion of the excess should be assigned to an unidentified intangible asset (goodwill) and should be accounted for according to applicable previous pronouncements of the Board and its predecessor committee. The cost of goodwill should not be amortized retroactively but may be amortized prospectively under the provision of APB Opinion No. 17, paragraph 35. If the cost of the investment is less than the investor's equity in the net assets of the combining company, that difference should reduce proportionately the recorded amounts of noncurrent assets (except long-term investments in marketable securities) of the combining company.

The Opinion entitled "Business Combinations" was adopted by the assenting votes of twelve members of the Board. Messrs. Broeker, Burger, Davidson, Horngren, Seidman, and Weston dissented.

Messrs. Broeker, Burger, and Weston dissent to issuance of this Opinion because they believe that it is not a sound or logical solution of the problem of accounting for business combinations. They believe that, except for combinations of companies whose

[14] Initiated as defined in paragraph 46-a whether the combination is accounted for by the pooling of interests method or by the purchase method.

relative size is such as to indicate a significant sharing of ownership risks and benefits, business combinations represent the acquisition or purchase of one company by another and that accounting should reflect that fact. While they agree that the criteria specified in this Opinion for the pooling of interests method represent, in most cases, an improvement over present criteria in practice, this action does not, in their opinion, represent a substantive response by the Accounting Principles Board to the overall problem.

Messrs. Davidson, Horngren, and Seidman dissent to the Opinion because it seeks to patch up some of the abuses of pooling. The real abuse is pooling itself. On that, the only answer is to eliminate pooling. Paragraphs 35 to 41 set forth some of the defects of pooling. The fundamental one is that pooling ignores the asset values on which the parties have traded, and substitutes a wholly irrelevant figure—the amount on the seller's books. Such nonaccounting for bargained acquisition values permits the reporting of profits upon subsequent disposition of such assets when there really may be less profit or perhaps a loss. Had the assets been acquired from the seller for cash, the buyer's cost would be the amount of the cash. Acquisition for stock should make no difference. The accounting essence is the amount of consideration, not its nature. Payment in cash or stock can be a matter of form, not substance. Suppose the seller wants cash. The buyer can first sell stock and turn over the proceeds to the seller, or the seller can take stock and promptly sell the stock for cash.

The following deal with some arguments made in the Opinion for pooling: (1) Pooling is described in paragraph 28 as a fusion resulting from "pooling equity interests." But it is the sort of fusion where a significant exchange transaction takes place. The seller parts with control over its assets and operations. In return the buyer issues stock representing an interest in its assets and operations. That interest has value and is a measure of the cost of the acquisition to the buyer. (2) Paragraph 29 declares that pooling is really a transaction among the stockholders. That just is not the fact. The buyer is always a company. (3) Paragraph 25 decries purchase accounting because it results in a write-up of only seller's assets. There is no write-up. There is only a recording of cost to the buyer. That cost is measured by the value of the assets acquired from the seller. (4) Pooling is said to avoid the difficulty of valuing assets or stock (paragraph 22). Difficulty of valuation should not be permitted to defeat fair presentation. Besides, the parties do determine values in their bargaining for the amount of stock to be issued.

Some say that to eliminate pooling will impede mergers. Mergers were prevalent before pooling, and will continue after. Accounting does not exist to aid or discourage mergers, but to account for them fairly. Elimination of pooling will remove the confusion that comes from the coexistence of pooling and purchase accounting. Above all, the elimination of pooling would remove an aberration in historical-cost accounting that permits an acquisition to be accounted for on the basis of the seller's cost rather than the buyer's cost of the assets obtained in a bargained exchange.

NOTES

Opinions of the Accounting Principles Board present the conclusions of at least two-thirds of the members of the Board, which is the senior technical body of the Institute authorized to issue pronouncements on accounting principles.

Board Opinions are considered appropriate in all circumstances covered but need not be applied to immaterial items.

Covering all possible conditions and circumstances in an Opinion of the Accounting Principles Board is usually impracticable. The substance of transactions and the principles, guides, rules, and criteria described in Opinions should control the accounting for transactions not expressly covered.

Unless otherwise stated, Opinions of the Board are not intended to be retroactive.

Council of the Institute has resolved that Institute members should disclose departures from Board Opinions in their reports as independent auditors when the effect of the departures on the financial statements is material or see to it that such departures are disclosed in notes to the financial statements and, where practicable, should disclose their effects on the financial statements (Special Bulletin, Disclosure of Departures from Opinions of the Accounting Principles Board, *October 1964). Members of the Institute must assume the burden of justifying any such departures.*

Accounting Principles Board (1970)

APB Opinion No. 17

INTANGIBLE ASSETS

AUGUST, 1970

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SUMMARY

Problem

1. An enterprise may acquire intangible assets from others or may develop them itself. Many kinds of intangible assets may be identified and given reasonably descriptive names, for example, patents, franchises, trademarks, and the like. Other types of intangible assets lack specific identifiability. Both identifiable and unidentifiable assets may be developed internally. Identifiable intangible assets may be acquired singly, as a part of a group of assets, or as part of an entire enterprise, but unidentifiable assets cannot be acquired singly. The excess of the cost of an acquired company over the sum of identifiable net assets, usually called goodwill, is the most common unidentifiable intangible asset.

2. Accounting for an intangible asset involves the same kinds of problems as accounting for other long-lived assets, namely, determining an initial carrying amount, accounting for that amount after acquisition under normal business conditions (amortization), and accounting for that amount if the value declines substantially and permanently. Solving the problems is complicated by the characteristics of an intangible asset: its lack of physical qualities makes evidence of its existence elusive, its value is often difficult to estimate, and its useful life may be indeterminable.

3. The Director of Accounting Research of the American Institute of Certified Public Accountants has published Accounting Research Study No. 10, *Accounting for Goodwill*, by George R. Catlett and Norman O. Olson.[1] The study emphasizes accounting for goodwill acquired in a business combination but also discusses accounting for goodwill developed internally. The study cites the supporting authoritative pronouncements and their influences on accounting practices and evaluates the effects of practices on financial reporting.

Scope and Effect of Opinion

4. The Board has considered the conclusions and recommendations of Accounting Research Study No. 10, the discussions of the appropriateness of accepted methods of accounting for intangible assets, and proposals for alternative accounting procedures. The Board expresses in this Opinion its conclusions on accounting for intangible assets.

5. This Opinion covers the accounting for both identifiable and unidentifiable intangible assets that a company acquires, including those acquired in business combinations. "Company" in this Opinion refers to both incorporated and unincorporated enterprises. The conclusions of the Opinion apply to intangible assets recorded, if any, on the acquisition of some or all of the stock held by minority stockholders of a subsidiary company. This Opinion also covers accounting for costs of developing goodwill and other unidentifiable intangible assets with indeterminate lives.

6. The provisions of this Opinion apply to costs of developing identifiable intangible assets that a company defers and records as assets. Some companies defer costs incurred to develop identifiable intangible assets while others record the costs as expenses as incurred. Certain costs, for example, research and development costs and preoperating costs, present problems which need to be studied separately. The question of deferral of those costs is beyond the scope of this Opinion.

7. This Opinion applies to regulated companies in accordance with the provisions of the Addendum to APB Opinion No. 2, *Accounting for the "Investment Credit,"* 1962.

8. The conclusions of this Opinion modify previous views of the Board and its predecessor, the Committee on Accounting Procedure. This Opinion therefore supersedes the following Accounting Research Bulletin (ARB) and Opinion of the Accounting Principles Board (APB):

ARB No. 43, Chapter 5, *Intangible Assets*, except paragraph 10 which is superseded by APB Opinion No. 16, *Business Combinations*.

APB Opinion No. 6, *Status of Accounting Research Bulletins*, paragraph 15.

Conclusions

9. The Board concludes that a company should record as assets the costs of intangible assets acquired from others, including goodwill acquired in a business combination. A company should record as expenses the costs to develop intangible assets which are not specifically identifiable. The Board also concludes that the cost of each type of intangible asset should be amortized by systematic charges to income over the period estimated to be benefited. The period of amortization should not, however, exceed forty years.

[1] Accounting research studies are not pronouncements of the Board or of the Institute but are published for the purpose of stimulating discussion on important accounting matters.

BACKGROUND

Bases of Classification

10. Various intangible assets differ in their characteristics, their useful lives, their relations to operations, and their later dispositions. Intangible assets may be classified on several different bases:

Identifiability — separately identifiable or lacking specific identification.

Manner of acquisition — acquired singly, in groups, or in business combinations or developed internally.

Expected period of benefit—limited by law or contract, related to human or economic factors, or indefinite or indeterminate duration.

Separability from an entire enterprise—rights transferable without title, salable, or inseparable from the enterprise or a substantial part of it.

Present Accounting

Accounting for Costs at Acquisition

11. Present principles of accounting for intangible assets are generally similar to those for tangible, long-lived assets such as property, plant, and equipment. Intangible assets acquired from other entities are recorded at cost when acquired. Costs incurred to develop specifically identifiable intangible assets are often recorded as assets if the periods of expected future benefit are reasonably determinable. Costs of developing other intangible assets are usually recorded as expenses when incurred.

Accounting for Deferred Costs After Acquisition

12. Intangible assets have been divided into two classes for purposes of accounting for their costs: (a) those with a determinable term of existence because it is limited by law, regulation, or agreement, or by the nature of the asset, and (b) those having no limited term of existence and no indication of limited life at the time of acquisition. The cost of a type (a) intangible asset is amortized by systematic charges to income over the term of existence or other period expected to be benefited. The cost of a type (b) intangible asset may be treated in either of two ways: (1) the cost may be retained until a limit on the term of existence or a loss of value is evident, at which time the cost is amortized systematically over the estimated remaining term of existence or, if worthless, written off as an extraordinary item in the income statement, or (2) the cost may be amortized at the discretion of management by charges to income even though no present evidence points to a limited term of existence or a loss of value.

13. The cost of an intangible asset, including goodwill acquired in a business combination, may not be written off as a lump sum to capital surplus or to retained earnings nor be reduced to a nominal amount at or immediately after acquisition (ARB No. 43, Chapter 5 and APB Opinion No. 9).

Criticism of Present Practice

14. Present accounting for goodwill and other unidentifiable intangible assets is often criticized because alternative methods of accounting for costs are acceptable. Some companies amortize the cost of acquired intangible assets over a short arbitrary period to reduce the amount of the asset as rapidly as practicable, while others retain the cost as an asset until evidence shows a loss of value and then record a material reduction in a single period. Selecting an arbitrary period of amortization is criticized because it may understate net income during the amortization period and overstate later net income. Retaining the cost as an asset is criticized because it may overstate net income before the loss of value is recognized and understate net income in the period of write-off.

Appraisal of Alternative Procedures

Cost of Intangible Assets

15. The cost of intangible assets acquired either singly or in groups, including intangible assets acquired in a business combination, from other businesses or individuals is determined by general principles of the historical-cost basis of accounting. The costs of developing goodwill and other intangible assets with indeterminate lives are ordinarily not distinguishable from the current costs of operations and are thus not assignable to specific assets.

Treatment of Costs

16. Costs of intangible assets which have fixed or reasonably determinable terms of existence are now amortized by systematic charges to income over their terms of existence. Differences of opinion center on the amortization of acquired intangible assets with lives which cannot be estimated reli-

ably either at the date of acquisition or perhaps long after, for example, goodwill and trade names.

17. The literature on business combinations and goodwill, including Accounting Research Study No. 10, *Accounting for Goodwill,* contains at least four possible accounting treatments of goodwill and similar intangible assets:

a. Retain the cost as an asset indefinitely unless a reduction in its value becomes evident.

b. Retain the cost as an asset but permit amortization as an operating expense over an arbitrary period.

c. Retain the cost as an asset but require amortization as an operating expense over its estimated limited life or over an arbitrary but specified maximum and minimum period.

d. Deduct the cost from stockholders' equity at the date acquired.

18. *Arguments for nonamortization.* The two of the four accounting proposals which do not involve amortization of goodwill as an operating expense are based in part on the contention that goodwill value is not consumed or used to produce earnings in the same manner as various property rights, and therefore net income should not be reduced by amortization of goodwill. Further, net income should not be reduced by both amortization of goodwill and current expenditures that are incurred to enhance or maintain the value of the acquired intangible assets. All methods of amortizing goodwill are criticized as arbitrary because the life of goodwill is indefinite and an estimated period of existence is not measurable.

19. The basis for proposing that the cost of goodwill be retained as an asset until a loss in value becomes evident is that the cost incurred for acquired goodwill should be accounted for as an asset at the date acquired and in later periods. The cost should not be reduced as long as the value of the asset is at least equal to that cost.

20. The basis for proposing that the cost of goodwill be deducted from stockholders' equity at the date acquired is that the nature of goodwill differs from other assets and warrants special accounting treatment. Since goodwill attaches only to a business as a whole and its value fluctuates widely for innumerable reasons, estimates of either the terms of existence or current value are unreliable for purposes of income determination.

Accounting on the Historical-Cost Basis

21. All assets which are represented by deferred costs are essentially alike in historical-cost based accounting. They result from expenditures or owners' contributions and are expected to increase revenue or reduce costs to be incurred in future periods. If future benefit or the period to be benefited is questionable, the expenditure is usually treated as a current expense and not as a deferred cost. Associating deferred costs with the revenue or period to which they are expected to relate is a basic problem in historical-cost based accounting both in measuring periodic income and in accounting for assets. The basic accounting treatment does not depend on whether the asset is a building, a piece of equipment, an element of inventory, a prepaid insurance premium, or whether it is tangible or intangible. The cost of goodwill and similar intangible assets is therefore essentially the same as the cost of land, buildings, or equipment under historical-cost based accounting. Deducting the cost of an asset from stockholders' equity (either retained earnings or capital in excess of par or stated value) at the date incurred does not match costs with revenue.

22. Accounting for the cost of a long-lived asset after acquisition normally depends on its estimated life. The cost of assets with perpetual existence, such as land, is carried forward as an asset without amortization, and the cost of assets with finite lives is amortized by systematic charges to income. Goodwill and similar intangible assets do not clearly fit either classification; their lives are neither infinite nor specifically limited, but are indeterminate. Thus, although the principles underlying present practice conform to the principles of accounting for similar types of assets, their applications have led to alternative treatments. Amortizing the cost of goodwill and similar intangible assets on arbitrary bases in the absence of evidence of limited lives or decreased values may recognize expenses and decreases of assets prematurely, but delaying amortization of the cost until a loss is evident may recognize the decreases after the fact.

A Practical Solution

23. A solution to this dilemma is to set minimum and maximum amortization periods. This accounting follows from the observation that few, if any, intangible assets last forever, although some may seem to last almost indefinitely. Allocating the cost of goodwill or other intangible assets with an

indeterminate life over time is necessary because the value almost inevitably becomes zero at some future date. Since the date at which the value becomes zero is indeterminate, the end of the useful life must necessarily be set aribitrarily at some point or within some range of time for acccounting purposes.

OPINION

Acquisition of Intangible Assets

24. The Board concludes that a company should record as assets the costs of intangible assets acquired from other enterprises or individuals. Costs of developing, maintaining, or restoring intangible assets which are not specifically identifiable, have indeterminate lives, or are inherent in a continuing business and related to an enterprise as a whole—such as goodwill—should be deducted from income when incurred.

25. *Cost of intangible assets.* Intangible assets acquired singly should be recorded at cost at date of acquisition. Cost is measured by the amount of cash disbursed, the fair value of other assets distributed, the present value of amounts to be paid for liabilities incurred, or the fair value of consideration received for stock issued as described in paragraph 67 of APB Opinion No. 16.

26. Intangible assets acquired as part of a group of assets or as part of an acquired company should also be recorded at cost at date of acquisition. Cost is measured differently for specifically identifiable intangible assets and those lacking specific identification. The cost of identifiable intangible assets is an assigned part of the total cost of the group of assets or enterprise acquired, normally based on the fair values of the individual assets. The cost of unidentifiable intangible assets is measured by the difference between the cost of the group of assets or enterprise acquired and the sum of the assigned costs of individual tangible and identifiable intangible assets acquired less liabilities assumed. Cost should be assigned to all specifically identifiable intangible assets; cost of identifiable assets should not be included in goodwill. Principles and procedures of determining cost of assets acquired, including intangible assets, are discussed in detail in paragraphs 66 to 89 of APB Opinion No. 16, *Business Combinations.*

Amortization of Intangible Assets

27. The Board believes that the value of intangible assets at any one date eventually disappears and that the recorded costs of intangible assets should be amortized by systematic charges to income over the periods estimated to be benefited. Factors which should be considered in estimating the useful lives of intangible assets include:

a. Legal, regulatory, or contractual provisions may limit the maximum useful life.

b. Provisions for renewal or extension may alter a specified limit on useful life.

c. Effects of obsolescence, demand, competition, and other economic factors may reduce a useful life.

d. A useful life may parallel the service life expectancies of individuals or groups of employees.

e. Expected actions of competitors and others may restrict present competitive advantages.

f. An apparently unlimited useful life may in fact be indefinite and benefits cannot be reasonably projected.

g. An intangible asset may be a composite of many individual factors with varying effective lives.

The period of amortization of intangible assets should be determined from the pertinent factors.

28. The cost of each type of intangible asset should be amortized on the basis of the estimated life of that specific asset and should not be written off in the period of acquisition. Analysis of all factors should result in a reasonable estimate of the useful life of most intangible assets. A reasonable estimate of the useful life may often be based on upper and lower limits even though a fixed existence is not determinable.

29. The period of amortization should not, however, exceed forty years. Analysis at the time of acquisition may indicate that the indeterminate lives of some intangible assets are likely to exceed forty years and the cost of those assets should be amortized over the maximum period of forty years, not an arbitrary shorter period.

30. *Method of amortization.* The Board concludes that the straight-line method of amortization—equal annual amounts—should be applied unless a company demonstrates that another systematic method is more appropriate. The financial statements should

disclose the method and period of amortization. Amortization of acquired goodwill and of other acquired intangible assets not deductible in computing income taxes payable does not create a timing difference, and allocation of income taxes is inappropriate.

31. *Subsequent review of amortization.* A company should evaluate the periods of amortization continually to determine whether later events and circumstances warrant revised estimates of useful lives. If estimates are changed, the unamortized cost should be allocated to the increased or reduced number of remaining periods in the revised useful life but not to exceed forty years after acquisition. Estimation of value and future benefits of an intangible asset may indicate that the unamortized cost should be reduced significantly by a deduction in determining net income (APB Opinion No. 9, paragraph 21). However, a single loss year or even a few loss years together do not necessarily justify an extraordinary charge to income for all or a large part of the unamortized cost of intangible assets. The reason for an extraordinary deduction should be disclosed.

Disposal of Goodwill

32. Ordinarily goodwill and similar intangible assets cannot be disposed of apart from the enterprise as a whole. However, a large segment or separable group of assets of an acquired company or the entire acquired company may be sold or otherwise liquidated, and all or a portion of the unamortized cost of the goodwill recognized in the acquisition should be included in the cost of the assets sold.

EFFECTIVE DATE

33. The provisions of this Opinion shall be effective to account for intangible assets acquired after October 31, 1970. Intangible assets recognized in business combinations initiated before November 1, 1970 and consummated on or after that date under the terms prevailing on October 31, 1970[8] may be accounted for in accordance with this Opinion or Chapter 5 of ARB No. 43 and APB Opinion No. 9.

34. The provisions of this Opinion should not be applied retroactively to intangible assets acquired before November 1, 1970, whether in business combinations or otherwise.

35. The Board encourages the application on a prospective basis to all intangible assets held on October 31, 1970 of the provisions in paragraphs 27 to 31 of this Opinion which require amortization of all intangible assets. Unless the provisions of this Opinion are applied prospectively, the accounting for intangible assets held on October 31, 1970 should be in accordance with Chapter 5 of ARB No. 43 as modified by APB Opinion No. 9.

The Opinion entitled "Intangible Assets" was adopted by the assenting votes of thirteen members of the Board. Messrs. Burger, Catlett, Davidson, Hellerson, and Horngren dissented.

Mr. Catlett dissents to this Opinion because he believes that goodwill should never be shown as an asset in the balance sheet and should never be amortized as a charge to income. In his view, goodwill, regardless of the form of consideration paid for it, reflects values brought about by investor expectations attributable to a multitude of factors. Such values fluctuate frequently and widely, and the changes do not occur in any rational, predictable manner. Thus, there is no continuing relationship between the value of goodwill and its cost. Goodwill does not have a demonstrable useful life; and its expiration, if any, cannot be related on any logical basis to the operating revenues of particular periods. If goodwill values from an earlier date and for only a portion of a combined company, and the arbitrary amortization of such values, are reflected in financial statements, an unwarranted responsibility is placed upon investors to make proper allowance for this misstatement of assets and distortion of earnings in appraising the earning power and the value of the combined company, including all of its goodwill, on a current basis. Mr. Catlett believes that the lack of recognition by the Accounting Principles Board of the true nature of goodwill, as discussed in Accounting Research Study No. 10, has resulted in conclusions which adversely affect the development of sound accounting principles far beyond the accounting for goodwill. He also believes this Opinion demonstrates in a dramatic manner the urgent need for the Accounting Principles Board to define clearly the objectives of financial statements if it is to deal successfully with basic accounting problems.

[8] Paragraphs 46-a and 47-a of APB Opinion No. 16, *Business Combinations*, define date initiated and describe the effect of changes in terms of a plan of combination.

Messrs. Burger, Davidson, Hellerson, and Horngren dissent to the required amortization of goodwill and other intangible assets (for example, perpetual franchises) having indeterminate lives. Whether amortization is appropriate depends on the particular circumstances of each case, including the evidence of increases or decreases in the value of such assets. In some cases, the facts may indicate maintenance or enhancement rather than diminution of value of the intangibles. In such cases, amortization is inappropriate. In other cases, the useful life may be determinable; then the cost should be amortized by systematic charges to income over the estimated period of usefulness. In all cases, the amortization of intangible assets should be based on professional judgment, rather than arbitrary rules.

NOTES

Opinions of the Accounting Principles Board present the conclusions of at least two-thirds of the members of the Board, which is the senior technical body of the Institute authorized to issue pronouncements on accounting principles.

Board Opinions are considered appropriate in all circumstances covered but need not be applied to immaterial items.

Covering all possible conditions and circumstances in an Opinion of the Accounting Principles Board is usually impracticable. The substance of transactions and the principles, guides, rules, and criteria described in Opinions should control the accounting for transactions not expressly covered.

Unless otherwise stated, Opinions of the Board are not intended to be retroactive.

Council of the Institute has resolved that Institute members should disclose departures from Board Opinions in their reports as independent auditors when the effect of the departures on the financial statements is material or see to it that such departures are disclosed in notes to the financial statements and, where practicable, should disclose their effects on the financial statements (Special Bulletin, Disclosure of Departures from Opinions of the Accounting Principles Board, *October 1964). Members of the Institute must assume the burden of justifying any such departures.*

APB STATEMENTS

. . . the full text of Statements issued by the Accounting Principles Board . . .

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APB Statement No. 1

STATEMENT BY THE ACCOUNTING PRINCIPLES BOARD

APRIL 13, 1962

The Accounting Principles Board has received *Accounting Research Study No. 3,* "A Tentative Set of Broad Accounting Principles for Business Enterprises," by Robert T. Sprouse and Maurice Moonitz. The Board previously had received *Accounting Research Study No. 1,* "The Basic Postulates of Accounting," by Maurice Moonitz. Study No. 1 was published in September 1961 and Study No. 3 is scheduled for publication toward the end of April 1962.

In the opinion of the Director of Accounting Research, these two studies comply with the instructions to the Accounting Research Division to make a study of the basic postulates and broad principles of accounting. Prior to its publication, Study No. 3 has been read and commented upon by a limited number of people in the field of accounting. Their reactions range from endorsement of the ideas set forth in the study of "Broad Principles" to misgivings that compliance with the recommendations set forth by the authors would lead to misleading financial statements. The Board is therefore treating these two studies (the one on "Postulates" and the other on "Principles") as conscientious attempts by the accounting research staff to resolve major accounting issues which, however, contain inferences and recommendations in part of a speculative and tentative nature.

The Board feels that there is ample room for improvement in present generally accepted accounting principles and a need to narrow or eliminate areas of difference which now exist. It hopes the studies will stimulate constructive comment and discussion in the areas of the basic postulates and the broad principles of accounting. Accounting principles and practices should be adapted to meet changing times and conditions, and, therefore, there should be experimentation with new principles and new forms of reporting to meet these conditions. The Board believes, however, that while these studies are a valuable contribution to accounting thinking, they are too radically different from present generally accepted accounting principles for acceptance at this time.

After a period of exposure and consideration, some of the specific recommendations in these studies may prove acceptable to the Board while others may not. The Board therefore will await the results of this exposure and consideration before taking further action on these studies.

APB Statement No. 2

DISCLOSURE OF SUPPLEMENTAL FINANCIAL INFORMATION BY DIVERSIFIED COMPANIES

SEPTEMBER, 1967

INTRODUCTION

1. Increasing attention is being given to the question of whether published reports of conglomerate companies should contain supplemental financial information concerning the activities of those segments of the business which are clearly separable into different industry lines. The term *conglomerate* is used popularly to describe a company that diversifies into distinctly different industries by acquisition or merger. The Board believes, however, that there is little distinction between industry diversification which arises by this method and industry diversification resulting from a company's own internal development and expansion efforts. All of these companies will be referred to in this statement by the more descriptive term *diversified companies.*

2. Disclosure of financial data relating to separable industry activities of a diversified company has not been considered essential for fair presentation of financial position and results of operations in conformity with generally accepted accounting principles. The Board recognizes, however, that financial reporting practices are not static and should be responsive to changes in the business environment. The increase in industry diversification by business enterprises is one aspect of the changing business environment which indicates a need for reexamination of financial reporting practices.

3. The Board believes it should consider financial reporting by diversified companies. Presently the Financial Executives Research Foundation is conducting a comprehensive study on this subject, some interested organizations are releasing "position" papers and other organizations are publishing views of individual authors. Upon completion and evaluation of these research activities and further study as may be deemed appropriate, the Board intends to issue a definitive pronouncement on the subject.

BACKGROUND

4. Unlike earlier merger movements, which were largely characterized as horizontal (companies joining with others in the same or related businesses) or vertical (companies joining with their suppliers or distributors into more integrated enterprises), the current merger activity has produced a significant number of business combinations which are neither horizontal nor vertical. Instead they represent the bringing together of companies in industries which are unrelated, or only slightly related.

5. Many companies, also, have accomplished industry diversification through internally generated activities, including the acquisition in some cases of comparatively small companies in other industries as a means of obtaining specialized industry knowledge. Some companies have broken away from an industry pattern with which they were previously identified and have entered entirely different fields to reduce dependence on a single market.

NEEDS OF THE INVESTOR AND HIS ADVISORS

6. Another major development has been the significant growth in the number of investors, as well as the growth in number of companies whose shares are publicly traded. Prominent in this growth has been the substantial increase in securities held by institutional investors (mutual funds, pension funds, insurance companies, foundations, etc.) with an increased emphasis on the role of the financial analyst. Analysts have frequently asserted the need for information concerning revenues and operating results of segments of diversified companies and have requested that it be furnished when it is not disclosed in published financial reports. These requests are a reaction by the analyst to the loss of corporate identification with a specific industry which has accompanied the development of complex diversified companies.

7. The Board recognizes that such information may be useful for investors in appraising the past performance and future risks and prospects of diversified companies.

REPORTING PROBLEMS

8. There appear to be few practical problems involved in determining sales or revenues for segments of a diversified company. However, determination of profitability by segments in a form suitable for reporting to investors raises many complex problems. Reporting profitability by segments may be practicable in those cases where the industry segments are relatively autonomous, rather than interdependent. There are many instances, however, where reporting on segments of a company's activities would require many estimates, assumptions, and arbitrary allocations and might result in information that would not be meaningful and could be misleading to investors. This is especially true where joint costs are involved or arbitrary transfer prices are used between major segments of a company.

COMPETITIVE ASPECTS

9. Concern has been expressed that supplemental financial information as to segments of the business may reveal valuable information to competitors and could be harmful to the company.

NEED FOR RESEARCH

10. Before a definitive pronouncement can be made, the Board believes that substantial research is necessary to provide practical guidelines for determining the extent to which such supplemental information is, in fact:

(a) needed by investors;

(b) reliable for investment decisions;

(c) not harmful to the company (that is, its present shareholders); and

(d) necessary for fair presentation of financial position and results of operations.

INTERIM RECOMMENDATION FOR DISCLOSURE

11. For the present, the Board urges diversified companies to review their own circumstances carefully and objectively with a view toward disclosing voluntarily supplemental financial information as to industry segments of the business.

12. An increasing trend by diversified companies to disclose such information is now evident. Specific examples of supplemental disclosures that are being made by some companies at the present time are as follows:

(a) Revenues by industry activity, or type of customer

(b) Revenues and profits by separable industry segments

(c) Separate financial statements of segments of the business which operate autonomously and employ distinctly different types of capital structure, such as insurance or bank subsidiaries of merchandising or manufacturing companies

(d) Revenues by type of industry activity and type of customer, together with a general indication of the profitability of each category

(e) Information that the operations of a segment of the enterprise are resulting in a loss, with or without disclosure of the amount of such loss.

CONCLUSION

13. The Board believes that the experience derived from voluntary disclosure efforts, together with the conclusions to be derived from research activities and further study, should provide it with a sound basis for making a definitive pronouncement in the future on the need for, and extent of, disclosure of supplemental financial information by diversified companies.

NOTE

This Statement is not an "Opinion of the Accounting Principles Board" as contemplated in the Special Bulletin, Disclosure of Departures from Opinions of the Accounting Principles Board, *October 1964. It is being issued as a special report for the information and assistance of members of the Institute and others interested in the subject. The Board may issue similar Statements in the future when it appears that preliminary analyses or observations on accounting matters should be issued in advance of research and study by the Board.*

APB Statement No. 3

FINANCIAL STATEMENTS RESTATED FOR GENERAL PRICE-LEVEL CHANGES

JUNE, 1969

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FOREWORD

This Statement sets forth the conclusions and recommendations of the Accounting Principles Board concerning general price-level information. Presentation of such information is not mandatory. The principles and procedures on which general price-level information is based have been tested (see paragraph 16 of the Statement) and have been discussed with representatives of organizations that have responsibilities which involve financial reporting.

INTRODUCTION

1. This Statement explains the effects on business enterprises and their financial statements of changes in the general purchasing power of money, describes the basic nature of financial statements restated for general price-level changes ("general price-level financial statements"), and gives general guidance on how to prepare and present these financial statements.[1]

2. In Chapter 9A of *Accounting Research Bulletin No. 43* (issued in 1953), the committee on accounting procedure stated that it ". . . gives its full support to the use of supplementary financial schedules, explanations or footnotes by which management may explain the need for retention of earnings [in the face of rising general price levels]." This section of *ARB 43* continues in "full force and effect without change" according to *APB Opinion 6*. The present Statement is an expansion of the ideas in Chapter 9A of *ARB 43;* it provides recommendations on how to prepare and present supplementary information restated for general price-level changes.

3. General price-level financial statements take into account changes in the general purchasing power of money. These changes are now ignored in preparing financial statements in the United States. In conventional financial statements the individual asset, liability, stockholders' equity, revenue, expense, gain, and loss items are stated in terms of dollars of the period in which these items originated. Conventional financial statements may be referred to as "historical-dollar financial statements."

4. The basic difference between general price-level and historical-dollar financial statements is the unit of measure used in the statements. In general price-level statements the unit of measure is defined in terms of a single specified amount of purchasing power—the general purchasing power of the dollar at a specified date. Thus, dollars which represent the same amount of general purchasing power are used in general price-level statements whereas dollars which represent diverse amounts of general purchasing power are used in historical-dollar statements.

5. The cost principle on which historical-dollar statements are based is also the basis of general price-level statements. In general, amounts shown at historical cost in historical-dollar statements are shown at historical cost restated for changes in the general purchasing power of the dollar in general price-level statements. The amount may be restated, but it still represents cost and not a current value. The process of restating historical costs in terms of a

[1] A more detailed discussion of general price-level financial statements is found in *Accounting Research Study No. 6*, "Reporting the Financial Effects of Price-Level Changes," by the Staff of the Accounting Research Division, American Institute of Certified Public Accountants, 1963. (Accounting research studies are not statements of this Board or of the Institute but are published for the purpose of stimulating discussion on important accounting matters.)

specified amount of general purchasing power does not introduce any factors other than general price-level changes. The amounts shown in general price-level financial statements are not intended to represent appraisal values, replacement costs, or any other measure of current value. (See Appendix D for further discussion.)

6. Changes in the general purchasing power of money have an impact on almost every aspect of economic affairs, including such diverse matters as investment, wage negotiation, pricing policy, international trade, and government fiscal policy. The effects of changes in the general purchasing power of money on economic data expressed in monetary terms are widely recognized, and economic data for the economy as a whole are commonly restated to eliminate these effects. General price-level financial statements should prove useful to investors, creditors, management, employees, government officials, and others who are concerned with the economic affairs of business enterprises.

BACKGROUND INFORMATION

Changes in the General Purchasing Power of Money

7. The general purchasing power of the dollar—its command over goods and services in general—varies, often significantly, from time to time. Changes in the general purchasing power of money are known as inflation or deflation. During inflation, the general purchasing power of money declines as the general level of prices of goods and services rises. During deflation, the general purchasing power of money increases as the general level of prices falls. The general purchasing power of money and the general price level are reciprocals.

8. A change in the general price level is a composite effect of changes in the prices of individual goods and services. The prices of all goods and services do not change at the same rate or in the same direction. Some rise while others fall, some rise or fall more rapidly than others, and some remain unchanged. This Statement is concerned with changes in the general purchasing power of money and therefore with changes in the *general* price level, not with changes in the relationships between *specific* prices of individual goods and services. (See Appendix D.)

Measuring General Price-Level Changes

9. Changes in the general price level are measured by the use of index numbers. The most comprehensive indicator of the general price level in the United States is the Gross National Product Implicit Price Deflator (GNP Deflator), issued quarterly by the Office of Business Economics of the Department of Commerce. The Consumer Price Index which is issued monthly by the Bureau of Labor Statistics of the Department of Labor is less inclusive than the GNP Deflator. Because of differences in coverage and in the system of weights used, the two indexes may change at different rates in the short run. Over the long run, however, the two indexes have changed at approximately the same rate.

10. Published general price-level indexes in the United States are stated in terms of a base year (currently 1958 for the GNP Deflator). Index numbers for current periods are expressed as percentages of the base year general price level. Through the use of indexes, amounts stated in terms of dollars at any point in time can be restated in terms of dollars of the base year of the index, dollars of the current year, or dollars of any year that is chosen. For example, the cost of land purchased for $10,000 in 1964 (GNP Deflator Index = 108.9) can be restated as 9,183 dollars of 1958 general purchasing power (index = 100.0) by multiplying the cost by 100.0/108.9, or as 11,185 dollars of 1968 general purchasing power (index = 121.8) by multiplying the cost by 121.8/108.9. In all three cases the cost is the same but the units in which it is expressed are different. Similarly, the general level of prices in 1968 may be stated as 121.8% of the general level of prices in 1958, or the general level of prices in 1958 may be stated as $\frac{100}{121.8}$ = 82.1% of the general level of prices in 1968.

11. General price levels seldom remain stable for long periods. For example, 35 of the 39 year to year changes in the United States GNP Deflator from 1929 to 1968 exceeded 1%. Ten of these changes were more than 5% and four were more than 10%. (See Appendix A.)

12. Although general price levels can and have moved both up and down, inflation has been the general rule throughout the world

for the last 30 years. Some countries have experienced slowly rising prices while others have experienced rapidly rising prices. The rise in the general price level in the United States, as measured by the GNP Deflator, was approximately 22% during the period 1958-1968 or a compound annual rate of 2% in contrast to approximately 130% in the preceding 20 years or a compound annual rate of about 4%. Price indexes in Brazil rose about 3,000% from 1958 to 1966. Inflation in China, Greece, and Hungary just before and after World War II was even more spectacular. General price-level increases of 25% to 50% per year have occurred recently in several countries.

Effects of General Price-Level Changes

13. The effects of inflation or deflation on a business enterprise and on its financial statements depend on (1) the amount of change in the general price level and (2) the composition of the assets and liabilities of the enterprise.

14. *Effects of Rate of Inflation.* Large changes in the general price level obviously have a greater effect than small changes. It is perhaps less obvious that moderate changes in the general price level may also significantly affect business enterprises and their financial statements. The nature of the income statement and the cumulative effect over time of moderate changes in the general price level tend to magnify the effects of changes in the general price level. Thus, in the income statement, differences which represent relatively small percentage changes in comparatively large revenue and expense items may be substantial in relation to net income. Also, if assets are held for a number of years the effect of inflation or deflation depends on the cumulative inflation or deflation since acquisition of the assets. The general price-level change in any one year is only a part of the total effect. Thus, the 3.8% inflation experienced in 1968 is only a small part of the total inflation effect on fixed assets appearing in 1968 statements. For fixed assets purchased in 1950, for example, there is a cumulative inflation effect of 54% (total inflation measured by the GNP Deflator from 1950 to 1968) on undepreciated cost and depreciation expense in 1968 general price-level financial statements. Furthermore, the effects of inflation compound over a period of years (for example, a constant 2% rate of inflation results in a 22% cumulative general prive-level change in ten years and a 49% cumulative general price-level change in 20 years). Nonrecognition of the effects of inflation may therefore have a substantial effect on financial statement representations of assets held over long periods (such as investments, and property, plant, and equipment), even though the amount of inflation each year has been relatively small.

15. *Effects of Different Kinds of Assets and Liabilities.* The holders of some types of assets and liabilities are affected differently by inflation and deflation than are the holders of other types of assets and liabilities. For example, holders of cash and similar assets always lose general purchasing power during a period of inflation, but holders of other assets may or may not lose general purchasing power during inflation. The effects on holders of different types of assets and liabilities are discussed more fully in paragraphs 17 to 23.

16. *Determining Combined Effects.* The effects of general price-level changes on a business enterprise and its financial statements therefore cannot be approximated by a simple adjustment. If users attempt to adjust for general price-level changes on an uninformed basis, they are likely to draw misleading inferences. The effects of general price-level changes can only be determined by comprehensive restatement of the items which comprise its financial statements. The need for comprehensive restatement was illustrated by a field test of general price-level restatement procedures.[3] For many companies in the test, net income was a smaller numerical amount on the general price-level basis than on the historical-dollar basis for the same period; for other companies it was a larger amount. The percentage differences between the amounts of net income for each company on the two bases varied widely, even with the relatively mild inflation in the United States in recent years.

Monetary and Nonmonetary Assets and Liabilities and General Price-Level Gains and Losses

17. During inflation, a given amount of money can be used to buy progressively fewer goods and services in general. Consequently, holders of money lose general purchasing power as a result of inflation. This loss

[3] See Paul Rosenfield, "Accounting for Inflation—A Field Test," *The Journal of Accountancy*, June 1969, pp. 45 to 50.

may be called a "general price-level loss."[3] General price-level losses also occur when certain other assets, mainly contractual claims to fixed amounts of money, are held during a period of inflation. The amount of money expected to be received represents a diminishing amount of general purchasing power simply as a result of the inflation. Similarly, a fixed amount of money payable in the future becomes less burdensome in a time of inflation because it is payable in dollars of reduced general purchasing power; those who owe money during inflation therefore have "general price-level gains." The effects of deflation are the opposite of the effects of inflation on holders of assets and liabilities of the type described in this paragraph.

18. Assets and liabilities are called "monetary" for purposes of general price-level accounting if their amounts are fixed by contract or otherwise in terms of numbers of dollars regardless of changes in specific prices or in the general price level. Holders of monetary assets and liabilities gain or lose general purchasing power during inflation or deflation simply as a result of general price-level changes.[4] Examples of monetary assets and liabilities are cash, accounts and notes receivable in cash, and accounts and notes payable in cash. General price-level gains and losses on monetary items cannot be measured in historical-dollar financial statements and are not now reported.

19. Assets and liabilities other than monetary items are called "nonmonetary" for general price-level accounting purposes. Examples of nonmonetary items are inventories, investments in common stocks, property, plant, and equipment, deferred charges which represent costs expended in the past, advances received on sales contracts, liabilities for rent collected in advance, deferred credits which represent reductions of prior expense, and common stock. Holders of nonmonetary items do not gain or lose general purchasing power simply as a result of general price-level changes. If the price of a nonmonetary item changes at the same rate as the general price level, no gain or loss of general purchasing power results. Holders of nonmonetary assets and liabilities gain or lose general purchasing power if the specific price of the item owned or owed rises or falls faster or slower than the change in the general price level. Holders of nonmonetary assets and liabilities also gain or lose general purchasing power if the specific price of a nonmonetary item remains constant while the general price level changes. Gains and losses on nonmonetary items differ from general price-level gains and losses on monetary items because they are the joint result of changes in the structure of prices (the relationships between specific prices) and changes in the general level of prices, and not the result simply of changes in the general price level. (See Appendix B for additional examples of monetary and nonmonetary items.)

20. Historical-dollar financial statements report gains and losses on nonmonetary items, usually when the items are sold, and corresponding gains and losses should also be reported in general price-level financial statements in the same time period as in the historical-dollar statements. The amounts reported as gains or losses may differ, however, because the costs and proceeds in the general price-level statements are restated for changes in the general price level. Thus, if the market price of an asset increases more than the increase in the general price level and the asset is sold, in historical-dollar statements the entire market price increase is shown as a gain in the period of sale but only the excess of the market price increase over the cost restated for the increase in the general price level is shown as a gain in the general price-level statements. The timing of reporting these gains and losses is the same in historical-dollar and general price-level financial statements but the amounts differ because of the effect of the change in the general price level. Similarly, if the asset is used instead of sold, depreciation or amortization deducted from the related revenue is reported in the same time periods in both historical-dollar and general price-level statements, although the amounts differ because

[3] Gains and losses of this type are often called "purchasing power gains and losses" in discussions of general price-level accounting (for example, see *Accounting Research Study No. 6*, page 137), but the Board prefers the term "general price-level gains and losses" to distinguish them from other gains and losses of general purchasing power experienced by business enterprises, such as those discussed in paragraph 19 of the Statement.

[4] See *Accounting Research Study No. 6*, page 137, for discussion of monetary and nonmonetary items in general price-level accounting. Assets and liabilities may be classified as "monetary" for purposes other than general price-level accounting. Classification of assets and liabilities as monetary for general price-level accounting purposes should be based on the fact that holders gain or lose general purchasing power simply as a result of general price-level changes rather than on criteria developed for other purposes.

of the restatement made in the general price-level statements. The Internal Revenue Code does not recognize general price-level restatements for tax purposes and income taxes are therefore assessed on the basis of historical-dollar amounts rather than amounts restated for general price-level changes. The income tax expense presented in general price-level statements is not computed in direct relationship to specific amounts of gains or losses on the statements or to the amount of net income before taxes. A few members of the Board believe that federal income tax should be allocated in general price-level statements to achieve a more direct relationship between the tax and various elements presented in these statements.

21. The fact that the market price of an item does not change over long periods of time does not in itself indicate that the item is monetary. Thus gold is nonmonetary because its price can fluctuate. The fact that the price did not fluctuate for over 30 years does not make gold a monetary item. When general price levels moved upward, the holder of gold lost general purchasing power because the price of his asset did not move as much as other prices, and not simply as a result of general price-level changes. Foreign currency, accounts receivable and payable in foreign currency, and similar items are also nonmonetary. The price of foreign currency, that is, the foreign exchange rate, can change. Therefore, the holder of foreign currency items does not gain or lose general purchasing power simply as a result of general price-level changes. If the exchange rate does not change when the general price level changes because of international controls or other factors, the price of foreign currency is rising or falling at a different rate than the general price level. The effect on the holder is the joint result of a change in the structure of prices and a change in the general level of prices, and therefore the items are nonmonetary. Even though foreign currency items are nonmonetary, they may be stated at the current foreign exchange rate in general price-level financial statements. Under these circumstances they would be treated as nonmonetary items carried at current market value.

22. A different viewpoint than that expressed in paragraph 21, held by a few Board members, is that foreign currency, accounts receivable and payable in foreign currency, and similar foreign currency items are similar to domestic monetary items. Foreign currency items should therefore be stated directly at the current (closing) foreign exchange rate in the general price-level balance sheet. The effect on the income of the holder of foreign currency items is the joint result of both the change in the foreign exchange rate and the change in the domestic general price level, and the items are therefore complex. Both effects are measurable, however, and should be disclosed separately. In the general price-level income statement, the effect of the general price-level change should be reported as a general price-level gain or loss on monetary items and the effect of the change in the exchange rate should be reported as a foreign exchange gain or loss. If the foreign exchange rate does not change, only a general price-level gain or loss should be reported.

23. A few assets and liabilities have characteristics of both monetary and nonmonetary items. For example, debentures held as an investment may have both a market price and fixed interest and principal payments. The fixed interest and principal payments do not change when prices change and therefore holders have general price-level gains or losses during inflation or deflation with respect to this characteristic. On the other hand, the market price of the debentures can and does change, and this feature does not yield general price-level gains or losses. Similarly, convertible debt owed is fixed in amount when considered as debt, but may be converted into capital stock. The fixed amount of debt owed is a monetary liability, which gives rise to general price-level gains or losses when general price levels change. The conversion feature is nonmonetary in nature, and does not give rise to gains or losses of general purchasing power simply as a result of general price-level changes. (See paragraph 34.)

General Price-Level Restatements

24. Economic data are commonly restated to eliminate the effects of changes in the general purchasing power of money. In the President's Economic Reports, National Income data of the United States, for example, have been restated in "constant" 1947-1949 dollars and "constant" 1954 dollars and are now expressed in "constant" 1958 dollars. The restatement procedures necessary for preparing general price-level financial statements are similar to those employed in restating other economic data. Some companies now use general price-level statements to report on their operations in countries in which the currency has suffered severe loss of general purchasing power.

RECOMMENDATIONS

25. The Board believes that general price-level financial statements or pertinent information extracted from them present useful information not available from basic historical-dollar financial statements. General price-level information may be presented in addition to the basic historical-dollar financial statements, but general price-level financial statements should not be presented as the basic statements. The Board believes that general price-level information is not required at this time for fair presentation of financial position and results of operations in conformity with generally accepted accounting principles in the United States.

26. The Board recognizes that the degree of inflation or deflation in an economy may become so great that conventional statements lose much of their significance and general price-level statements clearly become more meaningful, and that some countries have experienced this degree of inflation in recent years.[8] The Board concludes that general price-level statements reported in the local currency of those countries are in that respect in conformity with accounting principles generally accepted in the United States, and that they preferably should be presented as the basic foreign currency financial statements of companies operating in those countries when the statements are intended for readers in the United States.[9]

Restatement of Financial Statements

27. General guidelines for preparing general price-level statements, with explanatory comments, are set forth in paragraphs 28 to 46. More specific procedures are illustrated in Appendix C to this Statement.

28. *The same accounting principles used in preparing historical-dollar financial statements should be used in preparing general price-level financial statements except that changes in the general purchasing power of the dollar are recognized in general price-level financial statements.* General price-level financial statements are an extension of and not a departure from the "historical cost" basis of accounting. Many amounts in general price-level statements, however, are different from amounts in the historical-dollar statements because of the effects of changing the unit of measure.

29. *An index of the general price level, not an index of the price of a specific type of goods or services, should be used to prepare general price-level financial statements.* Price indexes vary widely in their scope; some measure changes in the prices of a relatively limited group of goods and services, such as construction costs or retail food prices in a specific city, while others measure changes in the prices of a broad group of goods and services in a whole economy. The purpose of the general price-level restatement procedures is to restate historical-dollar financial statements for changes in the general purchasing power of the dollar, and this purpose can only be accomplished by using a general price-level index.

30. Indexes which approximate changes in the general price level are now available for most countries. As noted in paragraph 9, the GNP Deflator is the most comprehensive indicator of the general price level in the United States. Consequently, it should normally be used to prepare general price-level statements in U. S. dollars.

31. The GNP Deflator is issued on a quarterly basis. The deflator for the last quarter of a year can ordinarily be used to approximate the index as of the end of the year. The Bureau of Labor Statistics Consumer Price Index has the practical advantage of being issued on a monthly basis. The consumer price index may therefore be used to approximate the GNP Deflator unless the two indexes deviate significantly.

32. *General price-level financial statements should be presented in terms of the general purchasing power of the dollar at the latest balance sheet date.* The Board has selected current general purchasing power as the basis for presentation because it believes that financial statements in "current dollars" are more relevant and more easily understood than those employing the general purchasing power of any other period. Current economic actions must take place in terms of current dollars, and restating items in current dollars expresses them in the context of current action.

33. *Monetary and nonmonetary items should be distinguished for the purpose of preparing general price-level financial statements.* Monetary items are stated in terms of current

[8] Although the Board believes that this conclusion is obvious with respect to some countries, it has not determined the degree of inflation or deflation at which general price-level statements clearly become more meaningful.

[9] This paragraph applies only to statements prepared in the currency of the country in which the operations reported on are conducted. Only conventional statements of foreign subsidiaries should be used to prepare historical-dollar consolidated statements.

general purchasing power in historical-dollar statements. General price-level gains and losses arise from holding moneary items. On the other hand, nonmonetary items are generally stated in terms of the general purchasing power of the dollar at the time they were acquired. Holding nonmonetary items does not give rise to general price-level gains and losses. Distinguishing monetary and nonmonetary items therefore permits (1) restatement of nonmonetary items in terms of current general purchasing power and (2) recognition of general price-level gains and losses on monetary items which are not recognized under historical-dollar accounting. Paragraphs 17 to 23 give criteria for distinguishing monetary and nonmonetary items for general price-level accounting purposes.

34. Assets and liabilities that have both monetary and nonmonetary characteristics (see paragraph 23) should be classified as monetary or nonmonetary based on the purpose for which they are held, usually evidenced by their treatment in historical-dollar accounting. Thus, carrying debentures at acquisition cost (perhaps adjusted to lower of cost and market) and classifying them as marketable securities provides evidence that market price may be important and the debentures may be nonmonetary. On the other hand, classifying debentures held as a long-term investment and amortizing premium or discount is evidence that the debentures are held for the fixed principal and interest and therefore are monetary assets. Similarly, convertible debt is usually treated as straight debt and therefore is usually a monetary liability.

35. *The amounts of nonmonetary items should be restated to dollars of current general purchasing power at the end of the period.* Nonmonetary items are typically stated in historical-dollar financial statements in terms of the general purchasing power of the dollar at the dates of the originating transactions. They should be restated by means of the general price index to dollars of current general purchasing power at the end of the period. Restatement of nonmonetary items does not introduce current values or replacement costs. For example, restatement of the cost of land that cost $100,000 in 1958 to $123,500 in 1968 statements does not imply that the market price of the land is $123,500 in 1968. Restatement merely presents the *cost* in a unit which represents the general purchasing power of the dollar at the end of 1968.

36. Nonmonetary items are sometimes already stated in historical-dollar financial statements in dollars of current general purchasing power, for example, inventory purchased near the end of the fiscal period or assets carried at current market price. The fact that the amount of an item is not changed in restatement does not necessarily identify it as a monetary item on which general price-level gains and losses should be computed.

37. Some nonmonetary items such as inventories are stated at the lower of cost and market in historical-dollar financial statements. These items should also be stated at the lower of cost and market in general price-level financial statements. Market may sometimes be below restated cost even though it is not below historical-dollar cost, and application of the cost or market rule will therefore sometimes result in a write-down to market in general price-level statements even though no write-down was required in the historical-dollar statements.

38. *Monetary assets and liabilities in the historical-dollar balance sheet are stated in dollars of current general purchasing power; consequently, they should appear in current general price-level statements at the same amounts.* The fact that the amounts of monetary assets and liabilities are the same in general price-level and historical-dollar statements should not obscure the fact that general price-level gains and losses result from holding them during a period of general price-level change (see paragraphs 17 and 18). Monetary assets and liabilities which appear in financial statements of prior periods presented for comparative purposes are updated to dollars of current general purchasing power by the "roll-forward" procedure described in paragraph 44.

39. *The amounts of income statement items should be restated to dollars of current general purchasing power at the end of the period.* Revenue and expenses are typically stated in historical-dollar statements in terms of the general purchasing power of the dollar at the dates of the originating transactions and should be restated by means of the general price index to dollars of current general purchasing power at the end of the period. The components of gains and losses (costs and proceeds) are also stated in terms of historical dollars and should be restated. All revenue, expenses, gains, and losses recognized under historical-dollar accounting are recognized in the same time period under general price-level accounting, but their

amounts are different in the case of items that are recorded in noncurrent dollars, such as depreciation, amortization, and cost of goods sold. Transactions that give rise to gains in historical-dollar financial statements may even give rise to losses in general price-level financial statements and vice versa. Income tax amounts in general price-level statements are based on income taxes reflected in historical-dollar statements and are not computed in direct relationship to the income before taxes on the general price-level statements.

40. *General price-level gains and losses should be calculated by means of the general price index and included in current net income.* General price-level gains and losses on monetary items described in paragraphs 17 and 18 should be calculated by restating the opening balances and transactions in the accounts for monetary assets and liabilities to dollars of general purchasing power at the end of the period and comparing the resulting restated balances at the end of the period with the actual balances at the end of the period. (See Appendix C.)

41. General price-level gains and losses on monetary items arise from changes in the general price level, and are not related to subsequent events such as the receipt or payment of money. Consequently, the Board has concluded that these gains and losses should be recognized as part of the net income of the period in which the general price level changes.

42. A different viewpoint than that expressed in paragraph 41, held by a Board member, is that all of a monetary gain should not be recognized in the period of general price-level increase. Under this view, a portion of the gain on net monetary liabilities in a period of general price-level increase should be deferred to future periods as a reduction of the cost of nonmonetary assets, since the liabilities represent a source of funds for the financing of these assets. The proponent of this view believes that the gain from holding net monetary liabilities during inflation is not realized until the assets acquired from the funds borrowed are sold or consumed in operations.[7] The Board does not agree with this view, however, because it believes that the gain accrues during the period of the general price-level increase and is unrelated to the cost of nonmonetary assets.

43. *General price-level gains and losses should be reported as a separate item in general price-level income statements.* General price-level gains and losses on monetary items are not part of the revenue and expenses reported in historical-dollar financial statements. They should be separately identified in the general price-level statements. General price-level gains may, however, be offset against general price-level losses and only a single figure representing net general price-level gain or loss for the period need be reported.

44. *General price-level financial statements of earlier periods should be updated to dollars of the general purchasing power at the end of each subsequent period for which they are presented as comparative information.* Statements of an earlier period are updated by multiplying each item by the ratio of the current general price level to the general price level of the earlier period. This "rolling forward" of earlier statements could cause confusion and convey the erroneous impression that previously reported information has been changed in substance rather than merely updated in terms of a later unit of measure.[8] Consequently, comparative general price-level financial statements and related financial information should be described in a way that makes clear that the general price-level statements of prior periods represent previously reported information updated to dollars of current general purchasing power to provide comparability with the current general price-level statements. (See paragraph 48, point f.)

45. *Restatement of financial statements of foreign branches or subsidiaries of U. S. companies for inclusion in combined or consolidated financial statements stated in terms of U. S. dollars should be based on an index of the general level of prices in the United States.* General price-level financial statements stated in terms of U. S. dollars use a unit of measure that represents the general purchasing power of the U. S. dollar at a specified

[7] For further discussion of this view see Marvin M. Deupree, "Accounting for Gains and Losses in Purchasing Power of Monetary Items" in *Accounting Research Study No. 6*, pp. 153-165.

[8] The "roll-forward" process results in stating financial statement items at different amounts than they were stated before being "rolled forward." The differences are not gains or losses but are merely differences between the same items measured in two different units of measure. If a cost stated at 100 dollars of general purchasing power current at the beginning of the year is "rolled forward" to 105 dollars of general purchasing power current at the end of the year, the difference of 5 is not a gain. It is similar, for example, to the difference of 2 between 1 yard and 3 feet.

date. An index of changes in the general purchasing power of the U. S. dollar should therefore be used to restate the financial statements of a company and its combined or consolidated foreign branches and subsidiaries. Financial statements of foreign branches or subsidiaries to be combined or consolidated with the financial statements of their United States parent company should first be translated into U. S. dollars using presently accepted methods and then restated for changes in the general purchasing power of the U. S. dollar.

46. *All general price-level information presented should be based on complete general price-level calculations.* Financial statements in which only some of the items, such as depreciation, have been restated disclose only part of the effects of changing general price levels on an enterprise. Partially restated financial statements and information based on them are likely to be misleading and should not be presented. General price-level information should therefore be based on complete calculations, although it need not be presented in the same detail as the historical-dollar financial statements. If any general price-level information is given, at least sales, net general price-level gains and losses on monetary items, extraordinary items, net income, and common stockholders' equity should be disclosed.

Presentation of General Price-Level Financial Information

47. Presentation of general price-level financial information as a supplement to the basic historical-dollar financial statements should be designed to promote clarity and minimize possible confusion. Because the two types of data are prepared on different bases, presentations of general price-level financial information should generally encourage comparisons with other general price-level data rather than with historical-dollar data. If general price-level financial statements are presented in their entirety, they preferably should be presented in separate schedules, not in columns parallel to the historical-dollar statements. Financial information extracted from general price-level statements (see paragraph 46) may be presented in either chart or narrative form, and may emphasize ratios and percentages instead of or in addition to dollar amounts.

48. The basis of preparation of general price-level information and what it purports to show should be clearly explained in the notes to the general price-level financial statements or other appropriate places. The explanation should include the following points:

a. The general price-level statements (or information) are supplementary to the basic historical-dollar financial statements [except as provided in paragraph 26].

b. All amounts shown in general price-level statements are stated in terms of units of the same general purchasing power by use of an index of changes in the general purchasing power of the dollar.

c. The general price-level gain or loss in the general price-level statements indicates the effects of inflation (or deflation) on the company's net holdings of monetary assets and liabilities. The company gains or loses general purchasing power as a result of holding these assets and liabilities during a period of inflation (deflation).

d. In all other respects, the same generally accepted accounting principles used in the preparation of historical-dollar statements are used in the preparation of general price-level statements (or information).

e. The amounts shown in the general price-level statements do not purport to represent appraised value, replacement cost, or any other measure of the current value of assets or the prices at which transactions would take place currently.

f. The general price-level statements (or information) of prior years presented for comparative purposes have been updated to current dollars. This restatement of prior years' general price-level statements is required to make them comparable with current information. It does not change the prior periods' statements in any way except to update the amounts to dollars of current general purchasing power.

49. Disclosure involving the following items should also be made:

a. The difference between the balance of retained earnings at the end of the preceding year in beginning-of-the-year dollars and at the beginning of the year in end-of-the-year dollars, which arises in the roll forward process discussed in paragraph 44, should be explained somewhat as follows:

Retained earnings at the beginning of the year:

Restated to general purchasing power at the beginning of the year xxx

Amount required to update to general purchasing power at the end of the year xxx

Restated to general purchasing power at the end of the year xxx

b. The fact should be disclosed that when assets are used or sold, federal income taxes are based on cost before restatement for general price-level changes because inflation is not recognized in the Internal Revenue Code.

The Statement entitled "Financial Statements Restated for General Price-Level Changes" was adopted unanimously by the eighteen members of the Board.

NOTE

Statements of the Accounting Principles Board present the conclusions of at least two-thirds of the members of the Board, which is the senior technical body of the Institute authorized to issue pronouncements on accounting principles. This Statement is not an "Opinion of the Accounting Principles Board" covered by action of the Council of the Institute in the Special Bulletin, Disclosure of Departures from Opinions of the Accounting Principles Board, *October 1964.*

Accounting Principles Board (1969)

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APPENDIX A

GROSS NATIONAL PRODUCT IMPLICIT PRICE DEFLATOR

Annual Averages 1929-1968

Quarterly Averages 1947-1968

Annual Averages

Year	Deflator (1958 = 100)	Percent Increase (Decrease) From Previous Year	Year	Deflator (1958 = 100)	Percent Increase (Decrease) From Previous Year
1929	50.6		1949	79.1	(.6)
1930	49.3	(2.6)	1950	80.2	1.4
1931	44.8	(9.1)	1951	85.6	6.7
1932	40.3	(10.0)	1952	87.5	2.2
1933	39.3	(2.5)	1953	88.3	.9
1934	42.2	7.4	1954	89.6	1.5
1935	42.6	.9	1955	90.9	1.5
1936	42.7	.2	1956	94.0	3.4
1937	44.5	4.2	1957	97.5	3.7
1938	43.9	(1.3)	1958	100.0	2.6
1939	43.2	(1.6)	1959	101.6	1.6
1940	43.9	1.6	1960	103.3	1.7
1941	47.2	7.5	1961	104.6	1.3
1942	53.0	12.3	1962	105.7	1.1
1943	56.8	7.2	1963	107.1	1.3
1944	58.2	2.5	1964	108.9	1.7
1945	59.7	2.6	1965	110.9	1.8
1946	66.7	11.7	1966	113.9	2.7
1947	74.6	11.8	1967	117.3	3.0
1948	79.6	6.7	1968	121.8	3.8

Quarterly Averages

Year	Quarter	Deflator
1947	1	73.0
	2	73.7
	3	74.9
	4	77.0
1948	1	78.2
	2	79.2
	3	80.6
	4	80.3
1949	1	79.7
	2	79.1
	3	78.8
	4	78.9
1950	1	78.3
	2	79.0
	3	80.8
	4	82.3
1951	1	84.8
	2	85.4
	3	85.6
	4	86.7
1952	1	86.7
	2	87.1
	3	87.7
	4	88.3
1953	1	88.4
	2	88.3
	3	88.4
	4	88.4
1954	1	89.5
	2	89.6
	3	89.5
	4	89.8
1955	1	90.2
	2	90.6
	3	91.0
	4	91.6
1956	1	92.6
	2	93.4
	3	94.6
	4	95.4
1957	1	96.4
	2	97.1
	3	98.0
	4	98.5
1958	1	99.3
	2	99.7
	3	100.1
	4	100.6

Quarterly Averages—continued

Year	Quarter	Deflator
1959	1	101.1
	2	101.4
	3	101.9
	4	102.1
1960	1	102.6
	2	103.0
	3	103.4
	4	104.0
1961	1	104.3
	2	104.5
	3	104.5
	4	105.1
1962	1	105.4
	2	105.5
	3	105.8
	4	106.2
1963	1	106.6
	2	107.0
	3	107.1
	4	107.8
1964	1	108.3
	2	108.4
	3	109.0
	4	109.6
1965	1	110.1
	2	110.7
	3	111.0
	4	111.6
1966	1	112.6
	2	113.5
	3	114.4
	4	115.3
1967	1	116.0
	2	116.6
	3	117.7
	4	118.9
1968	1	120.0
	2	121.2
	3	122.3
	4	123.5

Source: United States Department of Commerce, *Survey of Current Business,* issued monthly. Quarterly figures are available only since 1947. The deflators for 1929 to 1964 were recapitulated on pages 52 and 53 of the August 1965 issue of the *Survey.*

APPENDIX B

Monetary and Nonmonetary Items

Paragraphs 17 to 23 of the Statement present criteria for distinguishing between monetary and nonmonetary items for general price-level accounting purposes and give examples of each kind of item. This appendix provides additional examples, with an explanation of the reason for classification when needed.

Assets	Monetary	Non-monetary
Cash on hand and demand bank deposits (domestic currency)	X	
Time deposits (domestic currency)	X	
Foreign currency on hand and claims to foreign currency See discussion in Statement, paragraph 21.		X
Marketable securities		
Stocks		X
Bonds Bonds held as a short-term investment may be held for price speculation. If so, they are nonmonetary. If the bonds are held primarily for the fixed income characteristic, they are monetary.	(see discussion)	
Accounts and notes receivable	X	
Allowance for doubtful accounts and notes receivable	X	
Inventories produced under fixed price contracts accounted for at the contract price These items are in effect receivables of a fixed amount.	X	
Other inventories		X
Advances to employees	X	
Prepaid insurance, taxes, advertising, rent These represent an amount of services for which expenditures have been made and which will be amortized to expense in the future. In financial statements they are substantially the same kind of item as fixed assets.		X
Prepaid interest Related to notes payable, a monetary item.	X	
Receivables under capitalized financing leases	X	

Assets—continued	Monetary	Non-monetary
Long-term receivables	X	
Refundable deposits	X	
Advances to unconsolidated subsidiaries If there is no expectation that the advances will ever be collected, they are in effect additional investments and are nonmonetary.	X	
Investments in unconsolidated subsidiaries If an investment is carried at cost, it is nonmonetary. If an investment is carried on the equity basis, the statements of the subsidiary should be restated for general price-level changes (in accordance with paragraph 45 of the Statement for foreign affiliates) and the equity method should then be applied.	(see discussion)	
Pension, sinking, and other funds Depends on composition of the fund—bonds are generally monetary and stocks nonmonetary.	(see discussion)	
Investments in convertible bonds If the bond is held for price speculation or with expectation of converting into common stock the investment is nonmonetary. If the bond is held for the fixed principal and interest, it is monetary.	(see discussion)	
Property, plant, and equipment		X
Allowance for depreciation		X
Cash surrender value of life insurance	X	
Advances paid on purchase contracts The items to be received are nonmonetary.		X

	Monetary	Nonmonetary
Assets—continued		
Unamortized discount on bonds payable .... Related to bonds payable, a monetary item.	X	
Deferred charges for income taxes — deferred method A cost deferred as an expense of future periods is nonmonetary.		X
Other deferred charges which represent costs incurred to be charged against future income ..		X
Patents, trademarks, licenses, formulas		X
Goodwill		X
Other intangible assets...		X
Liabilities		
Accounts and notes payable	X	
Accrued expenses payable (salaries, wages, etc.) .. Similar to accounts payable, amount is fixed.	X	
Cash dividends payable ...	X	
Debts payable in foreign currency .... See Statement, paragraph 21.		X
Refundable deposits	X	
Advances received on sales contracts .... The obligation will be satisfied by delivery of goods that are nonmonetary.		X
Accrued losses on firm purchase commitments..	X	
Bonds payable	X	
Convertible bonds payable Treated as monetary debt until converted.	X	
Obligations under capitalized leases	X	
Other long-term debt	X	
Deferred taxes — deferred method .... Cost savings deferred as a reduction of expenses of future periods.		X

	Monetary	Nonmonetary
Liabilities—continued		
Deferred investment credits		X
Accrued pension cost	X	
Reserve for self-insurance Although reserve for self-insurance is nonmonetary, it may be stated in the same amount in both the historical-dollar and general price-level statements if the adequacy of the reserve in terms of current costs has been determined at year end for the historical-dollar statements.		X
Deferred income		X
Provision for guarantees.. Provision for guarantees is nonmonetary because it is a liability to provide goods or services. It may be stated in the same amount in both the historical-dollar and general price-level statements if the adequacy of the provision in terms of current costs has been determined at year end for the historical-dollar statements.		X
Accrued vacation pay .... Accrued vacation pay is monetary if it is based on a fixed contract. It is nonmonetary if it is payable based on wage or salary rates that may change after the balance sheet date.	(see discussion)	
Owners' Equity		
Minority interest		X
Preferred stock .... Classifying preferred stock as nonmonetary is based on the fact that the amount accounted for is the proceeds received when the stock was issued. The proceeds must be		X

	Monetary	Nonmonetary
Owners' Equity—continued		
restated to present them in terms of the general purchasing power of the dollar at the balance sheet date. The amount of a nonconvertible callable preferred stock should not exceed the call price in the general price-level balance sheet. The periodic change in the excess of the restated proceeds over the call price, if any, should not be included in net income, but should be added to net income to determine net income to common stockholders in the same manner as preferred dividends are deducted to determine net income to common stockholders. A different viewpoint held by some Board members is that preferred stock is a monetary item and that general price-level gains or losses from preferred stock outstanding should be included in the computation of net income.		
Common stock		X
Additional paid-in capital		X
Retained earnings .... Retained earnings is a residual and need not be classified as either monetary or nonmonetary.	(see discussion)	

APPENDIX C

PROCEDURES TO PREPARE FINANCIAL STATEMENTS RESTATED FOR GENERAL PRICE-LEVEL CHANGES

1. This appendix illustrates procedures to apply the general guidelines discussed in paragraphs 28 to 46 of this Statement. Procedures for restating historical-dollar financial statements for general price-level changes are described and illustrated for two years, 1967 and 1968. Restating the statements for 1967 illustrates the procedures for the first year of restatement; restating the 1968 statements illustrates the procedures for all subsequent years. The procedures for the first year a company restates its financial statements are more time consuming than those for subsequent years.

2. Financial statements used in this illustration contain a variety of items designed to demonstrate various facets of the restatement technique. Indexes of the general price-level changes which occurred in the United States in recent years are used. For convenience, the general assumptions used in the illustration are summarized below:

a. The XYZ Company was formed in 1957, ten years before the year for which its statements are first restated.

b. All significant costs of the year-end finished goods inventory, carried at FIFO, were incurred in the last quarter of the year; costs incurred before the last quarter of the year are assumed to be not material.

c. Year-end balances of raw materials and parts and supplies inventories, carried at FIFO, were acquired fairly evenly throughout the year.

d. Market value of inventories is above the restated cost of inventories, and the market price of inventories to be delivered is below the restated amount of deferred income.

e. Depreciation is computed on the straight-line basis. A full year's depreciation is taken in the year of acquisition, and no depreciation is taken in the year of sale. Depreciable assets have a ten-year life and no salvage value.

f. Sales, purchases, and selling and administrative expenses (other than depreciation, amortization of prepaid expenses, and deferred income realized) have taken place fairly evenly throughout the year, and federal income taxes accrue ratably throughout the year.

g. Interest expense is included in selling and administrative expenses.

3. To perform restatement procedures, a company needs (1) its historical-dollar financial statements for the year, (2) index numbers, and (3) conversion factors derived from the index numbers, as described in the following paragraphs.

4. The historical-dollar financial statements needed for the first year for which statements are to be restated are balance sheets at the beginning and end of the year and the statements of income, retained earnings, and other changes in owners' equity for the year. For each subsequent year, only the balance sheet at the end of the year and the statements of income, retained earnings, and other changes in owners' equity for the year are needed. The historical-dollar balance sheet at the beginning of the first year is restated to determine the restated amount of retained earnings at the beginning of the first year. In the illustration for the 1967 restatement, the historical-dollar balance sheets appear on page 9031 and the historical-dollar statement of income and retained earnings appears on page 9032. For the 1968 restatement, the historical-dollar balance sheet appears on page 9044 and the historical-dollar statement of income and retained earnings appears on page 9045.

5. The Gross National Product Implicit Price Deflator is used in the illustration as the index of changes in the general price level.[1] This index is available on both a quarterly and annual average basis. Indexes are needed for the average and the quarters for each year since the inception of the company or 1945[2], whichever is later. The annual average index may be used for any year in which its use would produce results not materially different from those which would be produced by using quarterly indexes. The index at the end of a year may be approximated by using the average for the last quarter of the year. To simplify the illustration, quarterly indexes are used only for 1967 and 1968. Indexes used in the 1967 restatement appear on page 9030. Indexes used in the 1968 restatement appear on page 9043. (Also see Appendix A.)

6. Conversion factors used in restatement are computed from general price-level index numbers by dividing the index number for the current balance sheet date by each of the other index numbers. To illustrate, assume that 1957 and 1960 expenditures are to be restated to dollars of December 1968 general purchasing power. The following GNP Deflators (general price-level index numbers) are applicable:

Average for 1957	97.5
Average for 1960	103.3
Fourth quarter 1968....	123.5

To compute the conversion factors for restatement to dollars of general purchasing power current at December 31, 1968, divide the index number for the fourth quarter of 1968 by each of the other index numbers:

1957: $123.5 \div 97.5 = 1.267$
1960: $123.5 \div 103.3 = 1.196$

To restate a nonmonetary item purchased in 1957, for example, its cost in 1957 dollars is multiplied by 1.267:

Cost in 1957 dollars.......	$1,500
	× 1.267
Cost in dollars current at December 31, 1968......	$1,900

The cost of $1,500 in 1957 dollars is equal to a cost of $1,900 in December 31, 1968 dollars. The cost is not changed; it is merely stated in a larger number of a smaller unit of measure. Conversion factors for the 1967 restatement are computed on page 9030. Conversion factors for the 1968 restatement are computed on page 9043.

7. The exhibits and worksheets which comprise the illustration are presented together on pages 9028 to 9052. Restatement procedures are discussed in eight steps on pages 9023 to 9026. Each step is first described in general terms and then keyed to the two years in an illustration below the general description.

[1] See paragraph 30 of the Statement.

[2] The precision of the measure of change in the general price level by any series of index numbers decreases over time because new commodities are continuously introduced and others disappear. No method has been devised to measure the percentage change in the general price level between two periods in which the bulk of commodities in either period is unique. A large portion of the dollar amount of current exchange transactions involves goods and services that originated in discoveries and innovations that grew out of the war effort (World War II) and postwar developments. Consequently, comparison of current prices with prices during and prior to World War II would probably not be reliable enough for accounting purposes because of the dissimilarity of goods and services exchanged then and now. A cutoff date is therefore indicated. The year 1945 is probably the earliest point that offers reasonable comparability of goods and services with later periods. All assets acquired, liabilities incurred, or owners' equity accumulated prior to 1945 should generally be treated as if they had originated during 1945.

General Steps to Prepare General Price-Level Financial Statements

STEP 1: *Identify monetary and nonmonetary assets and liabilities.*

The nature of each asset and liability item must be determined inasmuch as restatement procedures for monetary items are different from those for nonmonetary items as discussed in paragraphs 35-38 of the Statement. Paragraphs 17-23 of the Statement discuss the difference between monetary and nonmonetary items and give examples of each. Additional examples are given in Appendix B.

1967 Restatement

STEP 1: Monetary items in the December 31, 1966 and 1967 balance sheets on page 9031 are:

Cash
Receivables
Current liabilities
Long-term debt

Nonmonetary items are:
Marketable securities
Raw materials
Finished goods
Parts and supplies
Prepaid expenses
Property, plant, and equipment
Accumulated depreciation
Deferred income—payments received in advance*
Capital stock
Additional paid-in capital
Retained earnings

* Deferred income—payments received in advance is a nonmonetary liability because it represents an obligation to deliver nonmonetary assets—the company's products.

1968 Restatement

STEP 1: Monetary and nonmonetary items in the December 31, 1968 balance sheet on page 9044 are the same as in the December 31, 1966 and 1967 balance sheets.

STEP 2: *Analyze all nonmonetary items in the balance sheet of the current year (and the prior year for the first year of restatement) to determine when the component money amounts originated.*

Schedule the data by years, and by quarters whenever significant general price-level changes occurred during a year. If no significant general price-level changes occurred during a year, or if acquisitions were spread fairly evenly throughout a year, assume the items were acquired when the average general price level for the year was in effect. All balances accumulated prior to 1945 may be treated as if acquired in 1945. See Step 3 for treatment of special problems in restating inventories.

Retained earnings need not be analyzed. Retained earnings in the restated balance sheet at the beginning of the first year for which general price-level restatements are prepared can be computed as the balancing amount. This avoids the impractical alternative of restating all prior financial statements since the inception of the company. Retained earnings in subsequent restated balance sheets is determined from the restated statements of income and retained earnings.

1967 Restatement

STEP 2: Analysis of raw materials, finished goods, and parts and supplies inventories is discussed in notes 3 and 4 on page 9031. Marketable securities, capital stock, and additional paid-in capital are analyzed in columns 3, 5, and 7 on page 9033. Prepaid expenses, property, plant, and equipment, accumulated depreciation, and deferred income are analyzed in columns 3 to 6 on pages 9034 to 9037.

1968 Restatement

STEP 2: Much of the analysis needed for the 1968 restatement has been prepared for the 1967 restatement and merely needs to be updated. Analysis of raw materials, finished goods, and parts and supplies inventories, capital stock, and additional paid-in capital is discussed in notes 4, 5, and 6 on page 9044. Prepaid expenses, property, plant, and equipment, accumulated depreciation, and deferred income are analyzed in columns 3 to 6 on pages 9046 to 9049.

STEP 3: *Analyze all revenue, expense, gain, and loss items in the income statement of the current year, and all dividends and other changes in retained earnings during the year, to determine when the amounts originated that ultimately resulted in the charges and credits in the statements of income and retained earnings.*

A wide range in degree of difficulty is likely to be encountered in restating inventories and cost of goods sold to dollars of current general purchasing power. Raw materials priced on a first-in, first-out basis may already be in dollars of current general purchasing power and need no restatement. If turnover is rapid and spread fairly evenly throughout the year, purchases may be in dollars whose general purchasing power can be approximated by using the average general price level for the year. Restatement of inventories of work in process and finished goods, however, can be quite complicated and time consuming. Weighted average or last-in, first-out pricing increases the amount of detail.

Shortcuts to the restatement of inventories and purchases often produce results that do not differ enough from amounts derived by detailed computation to warrant the additional effort. For example, costs of inventories based on weighted average include, in part, every expenditure ever made to buy or produce them. A shortcut would be to assume that the beginning inventory had all been acquired in one turnover period. In the case of beginning LIFO inventories, using the assumption that different layers were acquired each year when the average general price level was in effect for that year will usually approximate the results of a detailed computation, purchase by purchase. Elements of overhead costs included in work in process and finished goods inventories can usually be restated from dollars of average general purchasing power for the year when overhead was applied to that segment of the inventory. Depreciation is the overhead cost element most likely to require extensive analysis, but only when the effect would be material.

Many revenue and expense items are, of course, recognized in the accounts at approximately the same time that the receipts and expenditures occurred (for example, salaries). If these items are spread fairly evenly throughout the year, it can be assumed that the receipts and expenditures all occurred when the average general price level for the year was in effect. When peak and slack periods occur during the year, and the general price level changes significantly between periods, revenue and expense items in this category should be determined for each calendar quarter.

The restatement of revenue and expense items should, of course, reconcile with the restatement of the related balance sheet accounts, and they can be restated as part of the same computation. For example, the beginning balance of merchandise inventory plus purchases, both stated in current dollars, should equal the sum of the cost of sales and the ending balance of merchandise inventory, also stated in current dollars.

1967 Restatement

STEP 3: Sales, cost of sales, selling and administrative expenses, and loss on sale of equipment are analyzed in column 1 on pages 9038 and 9039. Depreciation is analyzed in column 4 on page 9036. Amortization of prepaid expenses is analyzed in column 5 on page 9034. Deferred income realized is analyzed in column 5 on page 9037. Federal income taxes and dividends are analyzed on page 9032.

1968 Restatement

STEP 3: Sales, cost of sales, selling and administrative expenses, gain on sale of equipment, and gain or loss on sale of marketable securities are analyzed in column 1 on pages 9050 and 9051. Depreciation is analyzed in column 4 on page 9048. Amortization of prepaid expenses is analyzed in column 5 on page 9046. Deferred income realized is analyzed in column 5 on page 9049. Federal income taxes and dividends are analyzed on page 9045.

STEP 4: *Restate the nonmonetary items.*

Multiply the component amounts of nonmonetary items in the balance sheet of the current year (and the prior year for the first year of restatement) and in the statement of income and retained earnings for the current year by the conversion factors applicable to the components. The restated amount of each nonmonetary item is the sum of the restated amounts of its components.

1967 Restatement	*1968 Restatement*
STEP 4: Restatement of nonmonetary items is demonstrated on the pages in which the nonmonetary items are analyzed in accordance with Steps 2 and 3.	STEP 4: Restatement of nonmonetary items is demonstrated on the pages in which the nonmonetary items are analyzed in accordance with Steps 2 and 3. Components which originated in 1967 or earlier generally are restated by merely "rolling forward" their restated amounts from the worksheets for the 1967 restatement.

STEP 5: *Restate the monetary items in the balance sheet at the beginning of the first year.*

Monetary items in the balance sheet at the beginning of the first year for which statements are restated are stated in prior year dollars and are each restated to dollars of current general purchasing power by the conversion factor applicable to the end of the prior year. Monetary items in the balance sheet at the end of each year for which statements are restated are stated in dollars of current general purchasing power and need no restatement.

1967 Restatement	*1968 Restatement*
STEP 5: Restatement of the monetary items in the balance sheet at December 31, 1966 is discussed in note 1 on page 9031.	STEP 5: (Not applicable after the first year statements are restated.)

STEP 6: *Apply the "cost or market" rule after restatement to the items to which it applies before restatement.*

To determine that marketable securities and inventories are not stated above market in the restated statements, and that current nonmonetary liabilities are not stated below market, the restated amounts are compared with market and adjusted if necessary.

1967 Restatement	*1968 Restatement*
STEP 6: Market is assumed to be higher than restated marketable securities and inventories and lower than restated deferred income.	STEP 6: Market is assumed to be higher than restated inventories and lower than restated deferred income.

STEP 7: *Compute the general price-level gain or loss for the current year.*

The general price-level gain or loss which arises from holding net balance sheet monetary items during inflation or deflation appears in the general price-level statements but does not appear in the historical-dollar statements. The format used to prepare a statement of source and application of net balance sheet monetary items is a convenient device to use in calculating the general price-level gain or loss. In this calculation the items which cause changes in the monetary items are analyzed and the net balance of the monetary items if there were no gain or loss is determined. A comparison of this net balance with the actual net balance of monetary items at the balance sheet date determines the gain or loss.

1967 Restatement	*1968 Restatement*
STEP 7: The general price-level gain for 1967 is computed on page 9040.	STEP 7: The general price-level gain for 1968 is computed on page 9052.

STEP 8: *"Roll forward" the restated statements of the prior year to dollars of current general purchasing power.*

Financial statements of the prior year which were restated to dollars current at the end of the prior year are restated to dollars current at the end of the current year simply by multiplying each amount by the conversion factor applicable to the end of the prior year. This "rolling forward" serves two purposes: (1) it provides the amount of retained earnings at the end of the prior year in current dollars for the current year statement of retained earnings, and (2) it provides the prior year statements in current dollars for use as comparative statements.

1967 Restatement

STEP 8: (Not applicable for the first year statements are restated.)

1968 Restatement

STEP 8: The restated balance sheet at the end of 1967 is "rolled forward" in columns 1 and 2 on page 9044. The restated statement of income and retained earnings for 1967 is "rolled forward" in columns 1 and 2 on page 9045.

EXHIBITS AND WORKSHEETS ILLUSTRATING RESTATEMENT

1967 Restatement—XYZ Company

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1968 Restatement—XYZ Company

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R-9	—Analysis of Expenses	9051
R-10	—General Price-Level Gain	9052

EXHIBIT A

XYZ Company
General Price-Level Balance Sheet
December 31, 1967

ASSETS	General Price-Level Basis (Restated to 12/31/67)
Current assets:	
Cash	$(67) 1,700,000
Marketable securities, at cost	1,654,000
Receivables (net)	5,050,000
Inventories, at the lower of cost and market on a first-in, first-out basis:	
Raw materials	2,849,000
Finished goods	2,560,000
Parts and supplies	578,000
Prepaid expenses	49,000
Total current assets	14,440,000
Property, plant, and equipment, at cost	29,580,000
Less: Accumulated depreciation	21,156,000
	8,424,000
	$(67)22,864,000

LIABILITIES AND STOCKHOLDERS' EQUITY	
Current liabilities	$(67) 4,770,000
Deferred income—payments received in advance	101,000
Long-term debt	5,000,000
Stockholders' equity:	
Capital stock — common	2,109,000
Additional paid-in capital	3,785,000
Retained earnings	7,099,000
Total stockholders' equity	12,993,000
	$(67)22,864,000

EXHIBIT B

XYZ Company
General Price-Level Statement of Income and Retained Earnings
Year Ended December 31, 1967

	General Price-Level Basis (Restated to 12/31/67)
Sales	$(67)30,424,000
Operating expenses:	
Cost of sales	23,232,000
Depreciation	2,616,000
Selling and administrative expenses	2,615,000
	28,463,000
Operating profit	1,961,000
Loss on sale of equipment	(12,000)
General price-level gain	138,000
	126,000
Income before federal income taxes	2,087,000
Federal income taxes	923,000
Net income	1,164,000
Retained earnings, December 31, 1966	6,137,000
	7,301,000
Less: Dividends paid	202,000
Retained earnings, December 31, 1967	$(67) 7,099,000

12/31/67
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XYZ COMPANY
General Price-Level Restatement—1967
Gross National Product Implicit Price Deflators and Conversion Factors

Year	*Quarter*	*GNP deflators*	*Conversion factors 1967 (4th q.) = 1.000*
Annual average			
1957		97.5	1.219
1958		100.0	1.189
1959		101.6	1.170
1960		103.3	1.151
1961		104.6	1.137
1962		105.7	1.125
1963		107.1	1.110
1964		108.9	1.092
1965		110.9	1.072
1966		113.9	1.044
1967		117.3	1.014
Quarterly			
1966	4th	115.3	1.031
1967	1st	116.0	1.025
	2nd	116.6	1.020
	3rd	117.7	1.010
	4th	118.9	1.000

Source: *Survey of Current Business,* U.S. Department of Commerce, Office of Business Economics (Deflators of 1957-1964 from issue of August, 1965, page 53)

12/31/67
R-2

XYZ COMPANY
General Price-Level Restatement—1967
Working Balance Sheets—12/31/66 and 12/31/67

	12/31/66			12/31/67		
	Historical	Conversion factor or source	Restated to 12/31/67 $'s	Historical	Conversion factor or source	Restated to 12/31/67 $'s
Assets						
Cash	810,000	(1) 1.031	835,110	1,700,000	(2)	1,700,000
Marketable securities (at cost)	1,470,000	R-4	1,623,340	1,500,000	R-4	1,654,090
Receivable—net	1,900,000	(1) 1.031	1,958,900	5,050,000	(2)	5,050,000
Inventories						
Raw materials (FIFO)	2,680,000	(3) 1.044	2,797,920	2,810,000	(3) 1.014	2,849,340
Finished goods (FIFO)	2,450,000	(4) 1.031	2,525,950	2,560,000	(4) 1.000	2,560,000
Parts and supplies (FIFO)	700,000	(3) 1.044	730,800	570,000	(3) 1.014	577,980
Prepaid expenses	50,000	R-5	52,720	48,000	R-5	49,261
Total current assets	10,060,000		10,524,740	14,238,000		14,440,671
Property, plant, and equipment (at cost)	25,400,000	R-6	29,154,200	25,900,000	R-6	29,579,550
Less: Accumulated depreciation	16,350,000	R-7	19,016,680	18,260,000	R-7	21,156,145
	9,050,000		10,137,520	7,640,000		8,423,405
	19,110,000		20,662,260	21,878,000		22,864,076
Liabilities						
Current liabilities	2,950,000	(1) 1.031	3,041,450	4,770,000	(2)	4,770,000
Deferred income—payments received in advance	120,000	R-8	125,280	100,000	R-8	100,900
Long-term debt	5,300,000	(1) 1.031	5,464,300	5,000,000	(2)	5,000,000
	8,370,000		8,631,030	9,870,000		9,870,900
Stockholders' Equity						
Capital stock—common	1,760,000	R-4	2,109,120	1,760,000	R-4	2,109,120
Additional paid-in capital	3,150,000	R-4	3,784,550	3,150,000	R-4	3,784,550
Retained earnings	5,830,000	(5)	6,137,560	7,098,000	R-3	7,099,506
	10,740,000		12,031,230	12,008,000		12,993,176
	19,110,000		20,662,260	21,878,000		22,864,076

Notes

(1) 12/31/66 monetary items before restatement are stated in 12/31/66 $'s. The conversion factor for the end of 1966 is used to restate them to 12/31/67 $'s.

(2) 12/31/67 monetary items need no restatement because they are stated in 12/31/67 $'s.

(3) Year-end balance assumed acquired fairly evenly throughout the year.

(4) Assumed that all significant costs of year-end finished goods were incurred in last quarter of the year. Costs incurred before last quarter of the year (e g., depreciation) assumed not material.

(5) 12/31/66 retained earnings restated in the amount which makes the balance sheet balance.

XYZ COMPANY 12/31/67

General Price-Level Restatement—1967 R-3

Working Statement of Income and Retained Earnings

	Historical	Conversion factor or source	Restated to 12/31/67 $'s
Sales	30,000,000	R-9	30,424,220
Operating expenses:			
Cost of sales (except depreciation)	22,735,000	R-9	23,232,180
Depreciation	2,310,000	R-7	2,616,635
Selling and administrative expenses	2,577,000	R-10	2,614,704
	27,622,000		28,463,519
Operating profit	2,378,000		1,960,701
Loss of sale of equipment	-0-	R-10	(11,730)
General price-level gain	-0-	R-11	137,715
	-0-		125,985
Income before federal income taxes	2,378,000		2,086,686
Federal income taxes	910,000	(1) 1.014	922,740
Net income	1,468,000		1,163,946
Retained earnings—12/31/66	5,830,000	R-2	6,137,560
	7,298,000		7,301,506
Dividends paid			
June 1967	100,000	1.020	102,000
December 1967	100,000	1.000	100,000
	200,000		202,000
Retained earnings—12/31/67	7,098,000		7,099,506

(1) Assumed accrued ratably throughout the year

XYZ COMPANY 12/31/67

General Price-Level Restatement—1967 R-4

Analysis of Marketable Securities, Capital Stock, and Additional Paid-in Capital

Year acquired	Factor to restate to 12/31/67 $'s	Marketable securities Historical	Marketable securities Restated to 12/31/67 $'s	Capital stock Historical	Capital stock Restated to 12/31/67 $'s	Additional paid-in capital Historical	Additional paid-in capital Restated to 12/31/67 $'s
1957	1.219			1,000,000	1,219,000	2,000,000	2,438,000
1958	1.189			500,000	594,500	750,000	891,750
1959	1.170						
1960	1.151						
1961	1.137	500,000	568,500	260,000	295,620	400,000	454,800
1962	1.125						
1963	1.110						
1964	1.092	750,000	819,000				
1965	1.072	220,000	235,840				
1966	1.044						
Balances 12/31/66		1,470,000	1,623,340	1,760,000	2,109,120	3,150,000	3,784,550
1967							
1st q.	1.025	30,000	30,750				
2nd q.	1.020						
3rd q.	1.010						
4th q.	1.000						
average	1.014						
Balances 12/31/67		1,500,000	1,654,090	1,760,000	2,109,120	3,150,000	3,784,550

Note: All marketable securities assumed to be nonmonetary

XYZ COMPANY

General Price-Level Restatement—1967 12/31/67

Analysis of Prepaid Expenses R-5

Year acquired	Factor to restate to 12/31/67 $'s	Historical: Balance 12/31/66	Historical: Additions	Historical: Amortization	Historical: Balance 12/31/67	Restated to 12/31/67 $'s: Balance 12/31/66	Restated: Additions	Restated: Amortization	Restated: Balance 12/31/67
1964	1.092	5,000		5,000		5,460		5,460	
1965	1.072	10,000		7,000	3,000	10,720		7,504	3,216
1966	1.044	35,000		25,000	10,000	36,540		26,100	10,440
1967									
1st q.	1.025		25,000	8,000	17,000		25,625	8,200	17,425
2nd q.	1.020								
3rd q.	1.010		20,000	2,000	18,000		20,200	2,020	18,180
4th q.	1.000								
		50,000	45,000	47,000	48,000	52,720	45,825	49,284	49,261

XYZ COMPANY

General Price-Level Restatement—1967 12/31/67

Analysis of Property, Plant, and Equipment R-6

Year acquired	Factor to restate to 12/31/67 $'s	Historical: Balance 12/31/66	Historical: Additions	Historical: Retirements	Historical: Balance 12/31/67	Restated to 12/31/67 $'s: Balance 12/31/66	Restated: Additions	Restated: Retirements	Restated: Balance 12/31/67
1957	1.219	3,000,000		200,000	2,800,000	3,657,000		243,800	3,413,200
1958	1.189	3,000,000		100,000	2,900,000	3,567,000		118,900	3,448,100
1959	1.170	4,000,000		100,000	3,900,000	4,680,000		117,000	4,563,000
1960	1.151	3,600,000			3,600,000	4,143,600			4,143,600
1961	1.137	800,000			800,000	909,600			909,600
1962	1.125	5,000,000			5,000,000	5,625,000			5,625,000
1963	1.110	3,000,000			3,000,000	3,330,000			3,330,000
1964	1.092	2,000,000		100,000	1,900,000	2,184,000		109,200	2,074,800
1965	1.072	500,000			500,000	536,000			536,000
1966	1.044	500,000			500,000	522,000			522,000
1967									
1st q.	1.025		250,000		250,000		256,250		256,250
2nd q.	1.020		300,000		300,000		306,000		306,000
3rd q.	1.010		200,000		200,000		202,000		202,000
4th q.	1.000		250,000		250,000		250,000		250,000
		25,400,000	1,000,000	500,000	25,900,000	29,154,200	1,014,250	588,900	29,579,550

XYZ COMPANY
General Price-Level Restatement—1967
Analysis of Accumulated Depreciation

12/31/67
R-7

Year assets acquired	Factor to restate to 12/31/67 $'s	Historical				Restated to 12/31/67 $'s			
		Balance 12/31/66	Depreciation (1)	Retirements	Balance 12/31/67	Balance 12/31/66	Depreciation (1)	Retirements	Balance 12/31/67
1957	1.219	3.000,000		200,000	2,800,000	3,657,000		243,800	3,413,200
1958	1.189	2,700,000	290,000	90,000	2,900,000	3,210,300	344,810	107,010	3,448,100
1959	1.170	3,200,000	390,000	80,000	3,510,000	3,744,000	456,300	93,600	4,106,700
1960	1.151	2,520,000	360,000		2,880,000	2,900,520	414,360		3,314,880
1961	1.137	480,000	80,000		560,000	545,760	90,960		636,720
1962	1.125	2,500,000	500,000		3,000,000	2,812,500	562,500		3,375,000
1963	1.110	1,200,000	300,000		1,500,000	1,332,000	333,000		1,665,000
1964	1.092	600,000	190,000	30,000	760,000	655.200	207.480	32,760	829,920
1965	1.072	100,000	50,000		150,000	107,200	53,600		160,800
1966	1.044	50,000	50,000		100,000	52,200	52,200		104,400
1967									
1st q.	1.025		25,000		25,000		25,625		25,625
2nd q.	1.020		30,000		30,000		30,600		30,600
3rd q.	1.010		20,000		20,000		20,200		20,200
4th q.	1.000		25,000		25,000		25,000		25,000
		16,350,000	2,310,000	400,000	18,260,000	19,016,680	2,616,635	477,170	21,156,145

(1) Depreciation basis: Straight line
10 year life
No salvage value
Full year's depreciation in year of acquisition
No depreciation in year of disposition

12/31/67

R-8

XYZ COMPANY

General Price-Level Restatement—1967

Analysis of Deferred Income

Year acquired	Factor to restate to 12/31/67 $'s	Historical: Balance 12/31/66	Historical: Additions	Historical: Realized	Historical: Balance 12/31/67	Restated to 12/31/67 $'s: Balance 12/31/66	Restated to 12/31/67 $'s: Additions	Restated to 12/31/67 $'s: Realized	Restated to 12/31/67 $'s: Balance 12/31/67
1966	1.044	120,000		120,000		125,280		125,280	
1967									
1st q.	1.025		40,000	40,000			41,000	41,000	
2nd q.	1.020		50,000	30,000	20,000		51,000	30,600	20,400
3rd q.	1.010		50,000		50,000		50,500		50,500
4th q.	1.000		30,000		30,000		30,000		30,000
		120,000	170,000	190,000	100,000	125,280	172,500	196,880	100,900

XYZ COMPANY
General Price-Level Restatement—1967 12/31/67
Analysis of Sales and Cost of Sales R-9

	Historical	Conversion factor or source	Restated to 12/31/67 $'s
Sales			
Current sales	29,810,000	(1) 1.014	30,227,340
Deferred sales realized	190,000	R-8	196,880
Total sales	30,000,000		30,424,220
Cost of sales (except depreciation)			
Inventories 12/31/66			
Raw materials	2,680,000	R-2	2,797,920
Finished goods	2,450,000	R-2	2,525,950
Parts and supplies	700,000	R-2	730,800
Purchases during 1967	22,845,000	(1) 1.014	23,164,830
	28,675,000		29,219,500
Inventories 12/31/67			
Raw materials	2,810,000	R-2	2,849,340
Finished goods	2,560,000	R-2	2,560,000
Parts and supplies	570,000	R-2	577,980
	5,940,000		5,987,320
	22,735,000		23,232,180

(1) Spread fairly evenly throughout the year

XYZ COMPANY
General Price-Level Restatement—1967 12/31/67
Analysis of Expenses R-10

	Historical	Conversion factor or source	Restated to 12/31/67 $'s
Selling and administrative expenses			
Amortization of prepaid expenses	47,000	R-5	49,284
Other	2,530,000	(1) 1.014	2,565,420
	2,577,000		2,614,704

(1) Spread fairly throughout the year

	Historical	Conversion factor or source	Restated to 12/31/67 $'s
Loss on sale of equipment			
Cost	500,000	R-6	588,900
Accumulated depreciation	400,000	R-7	477,170
	100,000		111,730
Proceeds, December, 1967	100,000	1.000	100,000
Loss	-0-		11,730

XYZ COMPANY
General Price-Level Restatement—1967 12/31/67
General Price-Level Gain or Loss R-11

	Source	12/31/66 Historical	12/31/66 Restated to 12/31/67 $'s	12/31/67 Historical (stated in 12/31/67 $'s)
Net monetary items				
Cash	R-2	810,000	835,110	1,700,000
Receivables	R-2	1,900,000	1,958,900	5,050,000
Current liabilities	R-2	(2,950,000)	(3,041,450)	(4,770,000)
Long-term debt	R-2	(5,300,000)	(5,464,300)	(5,000,000)
		(5,540,000)	(5,711,740)	(3,020,000)

	Historical	Source	Restated to 12/31/67 $'s
General price-level gain or loss			
Net monetary items—12/31/66	(5,540,000)	as above	(5,711,740)
Add:			
Current sales	29,810,000	R-9	30,227,340
Additions to deferred income	170,000	R-8	172,500
Proceeds from sale of equipment	100,000	R-10	100,000
	24,540,000		24,788,100
Deduct:			
Purchases	22,845,000	R-9	23,164,830
Selling and administrative expenses—other	2,530,000	R-10	2,565,420
Federal income taxes	910,000	R-3	922,740
Dividends	200,000	R-3	202,000
Purchase of marketable securities	30,000	R-4	30,750
Purchases of property, plant, and equipment	1,000,000	R-6	1,014,250
Additions to prepaid expenses	45,000	R-5	45,825
	27,560,000		27,945,815
Net monetary items—historical—12/31/67 (as above)	(3,020,000)		
Net monetary items—restated—12/31/67 (if there were no gain)			(3,157,715)
Net monetary items—12/31/67 (as above)			(3,020,000)
General price-level gain			137,715

EXHIBIT A

XYZ Company
Comparative General Price-Level Balance Sheets
December 31, 1968 and December 31, 1967

	General Price-Level Basis (Restated to 12/31/68)	
ASSETS	Dec. 31, 1968	Dec. 31, 1967
Current assets:		
Cash	$(a) 2,120,000	$(a) 1,766,000
Marketable securities, at cost		1,719,000
Receivables (net)	6,170,000	5,247,000
Inventories, at the lower of cost and market on a first-in, first-out basis:		
Raw materials	2,575,000	2,960,000
Finished goods	2,390,000	2,660,000
Parts and supplies	621,000	601,000
Prepaid expenses	43,000	51,000
Total current assets	13,919,000	15,004,000
Property, plant, and equipment, at cost	31,208,000	30,733,000
Less: Accumulated depreciation	24,253,000	21,981,000
	6,955,000	8,752,000
	$(a)20,874,000	$(a)23,756,000

LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities	$(a) 2,521,000	$(a) 4,957,000
Deferred income – payments received in advance	51,000	105,000
Long-term debt	4,700,000	5,195,000
Stockholders' equity:		
Capital stock—common	2,191,000	2,191,000
Additional paid-in capital	3,932,000	3,932,000
Retained earnings	7,479,000	7,376,000
Total stockholders' equity	13,602,000	13,499,000
	$(a)20,874,000	$(a)23,756,000

EXHIBIT B

XYZ Company
Comparative General Price-Level Statements of Income and Retained Earnings Years Ended December 31, 1968 and December 31, 1967

	General Price-Level Basis (Restated to 12/31/68)	
	1968	1967
Sales	$(68)27,381,000	$(68)31,611,000
Operating expenses:		
Cost of sales	21,379,000	24,138,000
Depreciation	2,408,000	2,719,000
Selling and administrative expenses	2,658,000	2,717,000
	26,445,000	29,574,000
Operating profit	936,000	2,037,000
Gain (or loss) on sale of equipment	41,000	(12,000)
Loss on sale of securities	(118,000)	
General price-level gain	85,000	143,000
	8,000	131,000
Income before federal income taxes	944,000	2,168,000
Federal income taxes	639,000	959,000
Net income	305,000	1,209,000
Retained earnings, beginning of year	7,376,000	6,377,000
	7,681,000	7,586,000
Less: Dividends paid	202,000	210,000
Retained earnings, end of year	$(68) 7,479,000	$(68) 7,376,000

12/31/68
R-1

XYZ COMPANY
General Price-Level Restatement—1968
Gross National Product Implicit Price Deflators and Conversion Factors

Year	*Quarter*	*GNP deflators*	*Conversion factors 1968 (4th q.) = 1.000*
Annual average			
1957		97.5	1.267
1958		100.0	1.235
1959		101.6	1.216
1960		103.3	1.196
1961		104.6	1.181
1962		105.7	1.168
1963		107.1	1.153
1964		108.9	1.134
1965		110.9	1.114
1966		113.9	1.084
1967		117.3	1.053
1968		121.8	1.014
Quarterly			
1966	4th	115.3	1.071
1967	1st	116.0	1.065
	2nd	116.6	1.059
	3rd	117.7	1.049
	4th	118.9	1.039
1968	1st	120.0	1.029
	2nd	121.2	1.019
	3rd	122.3	1.010
	4th	123.5	1.000

Source: *Survey of Current Business,* U.S. Department of Commerce, Office of Business Economics

12/31/68
R-2

XYZ COMPANY
General Price-Level Restatement—1968
Working Balance Sheets—12/31/67 and 12/31/68

	12/31/67		12/31/68		
	Restated to 12/31/67 $'s (1)	Restated to 12/31/68 $'s (2)	Historical	Conversion factor or source	Restated to 12/31/68 $'s
Assets					
Cash	1,700,000	1,766,300	2,120,000	(3)	2,120,000
Marketable securities (at cost)	1,654,090	1,718,600			
Receivables—net	5,050,000	5,246,950	6,170,000	(3)	6,170,000
Inventories					
Raw materials (FIFO)	2,849,340	2,960,464	2,540,000	(4) 1.014	2,575,560
Finished goods (FIFO)	2,560,000	2,659,840	2,390,000	(5) 1.000	2,390,000
Parts and supplies (FIFO)	577,980	600,521	612,000	(4) 1.014	620,568
Prepaid expenses	49,261	51,182	42,000	R-4	43,030
Total current assets	14,440,671	15,003,857	13,874,000		13,919,158
Property, plant, and equipment (at cost)	29,579,550	30,733,153	26,400,000	R-5	31,208,277
Less: Accumulated depreciation	21,156,145	21,981,235	20,210,000	R-6	24,253,021
	8,423,405	8,751,918	6,190,000		6,955,256
	22,864,076	23,755,775	20,064,000		20,874,414
Liabilities					
Current liabilities	4,770,000	4,956,030	2,521,000	(3)	2,521,000
Deferred income—payments received in advance	100,900	104,835	50,000	R-7	50,490
Long-term debt	5,000,000	5,195,000	4,700,000	(3)	4,700,000
	9,870,900	10,255,865	7,271,000		7,271,490
Stockholders' Equity					
Capital stock—common	2,109,120	2,191,376	1,760,000	(6)	2,191,376
Additional paid-in capital	3,784,550	3,932,147	3,150,000	(6)	3,932,147
Retained earnings	7,099,506	7,376,387	7,883,000	R-3	7,479,401
	12,993,176	13,499,910	12,793,000		13,602,924
	22,864,076	23,755,775	20,064,000		20,874,414

Notes

(1) From R-2 of 12/31/67

(2) Each item "rolled-forward" from 12/31/67 $'s to 12/31/68 $'s by using conversion factor for the last quarter of 1967—1.039

(3) Monetary items—no restatement needed

(4) Year-end balance assumed acquired fairly evenly throughout the year.

(5) See note 4 in R-2 of 12/31/67

(6) No change in historical balances during 1968. The restated balances in the 12/31/68 balance sheet are therefore the same as the balances in the 12/31/67 balance sheet restated to 12/31/68 $'s in column 2 of this worksheet.

XYZ COMPANY
General Price-Level Restatement—1968
Working Statements of Income and Retained Earnings

12/31/68
R-3

	1967		1968		
	Restated to 12/31/67 $'s (1)	Restated to 12/31/68 $'s (2)	Historical	Conversion factor or source	Restated to 12/31/68 $'s
Sales	30,424,220	31,610,764	27,000,000	R-8	27,381,735
Operating expenses:					
Cost of sales (except depreciation)	23,232,180	24,138,235	20,856,000	R-8	21,379,109
Depreciation	2,616,635	2,718,684	2,070,000	R-6	2,407,937
Selling and administrative expenses	2,614,704	2,716,677	2,620,000	R-9	2,658,412
	28,463,519	29,573,596	25,546,000		26,445,458
Operating profit	1,960,701	2,037,168	1,454,000		936,277
Gain or (loss) on sale of equipment	(11,730)	(12,187)	61,000	R-9	41,354
Gain or (loss) on sale of securities			100,000	R-9	(118,600)
General price-level gain	137,715	143,086	-0-	R-10	84,703
	125,985	130,899	161,000		7,457
Income before federal income taxes	2,086,686	2,168,067	1,615,000		943,734
Federal income taxes	922,740	958,727	630,000	(3) 1.014	638,820
Net income	1,163,946	1,209,340	985,000		304,914
Retained earnings—beginning of year	6,137,560	6,376,925	7,098,000	R-2 (1967, 8)	7,376,387
	7,301,506	7,586,265	8,083,000		7,681,301
Dividends paid					
June 1968	102,000	105,978	100,000	1.019	101,900
December 1968	100,000	103,900	100,000	1.000	100,000
	202,000	209,878	200,000		201,900
Retained earnings—end of year	7,099,506	7,376,387	7,883,000		7,479,401

(1) From R-3 of 12/31/67
(2) Each item "rolled-forward" from 12/31/67 $'s to 12/31/68 $'s by using conversion factor for the last quarter of 1967—1.039
(3) Assumed accrued ratably throughout the year

XYZ COMPANY
General Price-Level Restatement—1968
Analysis of Prepaid Expenses

12/31/68
R-4

Year acquired	Factor to restate 1968 additions	Historical: Balance 12/31/67	Historical: Additions	Historical: Amortization	Historical: Balance 12/31/68	Balance 12/31/67 in 12/31/67 $'s (1)	Restated to 12/31/68 $'s: Balance 12/31/67 (2)	Restated to 12/31/68 $'s: Additions	Restated to 12/31/68 $'s: Amortization	Restated to 12/31/68 $'s: Balance 12/31/68
1965		3,000		3,000		3,216	3,341		(3) 3,341	
1966		10,000		8,000	2,000	10,440	10,847		(3) 8,678	2,169
1967										
1st q.		17,000		10,000	7,000	17,425	18,105		(3) 10,650	7,455
3rd q.		18,000		12,000	6,000	18,180	18,889		(3) 12,593	6,296
1968										
3rd q.	1.010		14,000	3,000	11,000			14,140	3,030	11,110
4th q.	1.000		20,000	4,000	16,000			20,000	4,000	16,000
		48,000	34,000	40,000	42,000	49,261	51,182	34,140	42,292	43,030

(1) From R-5 of 12/31/67

(2) Each item restated by factor for 4th quarter 1967—1.039

(3) Restated amortization is same percentage of restated 12/31/67 balance as historical amortization is of historical 12/31/67 balance.

XYZ COMPANY

General Price-Level Restatement—1968 12/31/68

Analysis of Property, Plant, and Equipment R-5

Year acquired	Factor to restate 1968 additions	Historical: Balance 12/31/67	Historical: Additions	Historical: Retirements	Historical: Balance 12/31/68	Balance 12/31/67 in 12/31/67 $'s (1)	Restated to 12/31/68 $'s: Balance 12/31/67 (2)	Restated to 12/31/68 $'s: Additions	Restated to 12/31/68 $'s: Retirements	Restated to 12/31/68 $'s: Balance 12/31/68
1957		2,800,000			2,800,000	3,413,200	3,546,315			3,546,315
1958		2,900,000			2,900,000	3,448,100	3,582,576			3,582,576
1959		3,900,000			3,900,000	4,563,000	4,740,957			4,740,957
1960		3,600,000			3,600,000	4,143,600	4,305,200			4,305,200
1961		800,000			800,000	909,600	945,074			945,074
1962		5,000,000			5,000,000	5,625,000	5,844,375			5,844,375
1963		3,000,000			3,000,000	3,330,000	3,459,870			3,459,870
1964		1,900,000		300,000	1,600,000	2,074,800	2,155,717		(3) 340,376	1,815,341
1965		500,000			500,000	536,000	556,904			556,904
1966		500,000			500,000	522,000	542,358			542,358
1967										
1st q.		250,000			250,000	256,250	266,244			266,244
2nd q.		300,000			300,000	306,000	317,934			317,934
3rd q.		200,000			200,000	202,000	209,878			209,878
4th q.		250,000			250,000	250,000	259,751			259,751
1968										
1st q.	1.029		300,000		300,000			308,700		308,700
2nd q.	1.019		200,000		200,000			203,800		203,800
3rd q.	1.010		300,000		300,000			303,000		303,000
4th q.										
		25,900,000	800,000	300,000	26,400,000	29,579,550	30,733,153	815,500	340,376	31,208,277

(1) From R-6 of 12/31/67

(2) Restated to 12/31/68 $'s by factor for 4th quarter 1967—1.039

(3) Restated retirement amount is same percentage of restated 12/31/67 balance as historical retirement amount is of historical 12/31/67 balance.

XYZ COMPANY
General Price-Level Restatement—1968
Analysis of Accumulated Depreciation

12/31/68
R-6

Year assets acquired	Factor to restate to 12/31/68 $'s	Historical: Balance 12/31/67	Historical: Depreciation (1)	Historical: Retirements	Historical: Balance 12/31/68	Balance 12/31/67 in 12/31/67 $'s (2)	Restated to 12/31/68 $'s: Balance 12/31/67 (4)	Restated to 12/31/68 $'s: Depreciation (1)	Restated to 12/31/68 $'s: Retirements	Restated to 12/31/68 $'s: Balance 12/31/68
1957		2,800,000			2,800,000	3,413,200	3,546,316			3,546,316
1958		2,900,000			2,900,000	3,448,100	3,582,576			3,582,576
1959		3,510,000	390,000		3,900,000	4,106,700	4,266,861	474,096		4,740,957
1960		2,880,000	360,000		3,240,000	3,314,880	3,444,160	430,520		3,874,680
1961		560,000	80,000		640,000	636,720	661,552	94,507		756,059
1962		3,000,000	500,000		3,500,000	3,375,000	3,506,625	584,437		4,091,062
1963		1,500,000	300,000		1,800,000	1,665,000	1,729,935	345,987		2,075,922
1964		760,000	160,000	120,000	800,000	829,920	862,287	181,534	(3) 136,151	907,670
1965		150,000	50,000		200,000	160,800	167,071	55,690		222,761
1966		100,000	50,000		150,000	104,400	108,472	54,236		162,708
1967										
1st q.		25,000	25,000		50,000	25,625	26,624	26,624		53,248
2nd q.		30,000	30.000		60,000	30,600	31,793	31,793		63,586
3rd q.		20,000	20,000		40,000	20,200	20,988	20,988		41,976
4th q.		25,000	25,000		50,000	25,000	25,975	25,975		51,950
1968										
1st q.	1.029		30,000		30,000			30,870		30,870
2nd q.	1.019		20,000		20,000			20,380		20,380
3rd q.	1.010		30,000		30,000			30,300		30,300
4th q.										
		18,260,000	2,070,000	120,000	20,210,000	21,156,145	21,981,235	2,407,937	136,151	24,253,021

(1) Depreciation basis: Straight line
10 year life
No salvage value
Full year's depreciation in year of acquisition
No depreciation in year of disposition

(2) From R-7 of 12/31/67

(3) Restated accumulated depreciation on assets retired is same percentage of restated 12/31/67 balance as historical accumulated depreciation on retirements is of historical 12/31/67 balance.

(4) Restated to 12/31/68 $'s by factor for 4th quarter 1967—1.039.

12/31/68
R-7

XYZ COMPANY
General Price-Level Restatement—1968
Analysis of Deferred Income

Year acquired	Factor to restate to 12/31/68 $'s	Historical: Balance 12/31/67	Historical: Additions	Historical: Realized	Historical: Balance 12/31/68	Balance 12/31/67 in 12/31/67 $'s (1)	Restated to 12/31/68 $'s: Balance 12/31/67 (2)	Restated to 12/31/68 $'s: Additions	Restated to 12/31/68 $'s: Realized	Restated to 12/31/68 $'s: Balance 12/31/68
1967										
2nd q.		20,000		20,000		20,400	21,196		21,196	
3rd q.		50,000		50,000		50,500	52,469		52,469	
4th q.		30,000		30,000		30,000	31,170		31,170	
1968										
1st q.	1.029		20,000	20,000				20,580	20,580	
2nd q.	1.019		10,000		10,000			10,190		10,190
3rd q.	1.010		30,000		30,000			30,300		30,300
4th q.	1.000		10,000		10,000			10,000		10,000
		100,000	70,000	120,000	50,000	100,900	104,835	71,070	125,415	50,490

(1) From R-8 of 12/31/67
(2) Each item restated by factor for 4th quarter 1967—1.039

XYZ COMPANY
General Price-Level Restatement—1968 12/31/68
Analysis of Sales and Cost of Sales R-8

	Historical	Conversion factor or source	Restated to 12/31/68 $'s
Sales			
Current sales	26,880,000	(1) 1.014	27,256,320
Deferred sales realized	120,000	R-7	125,415
Total sales	27,000,000		27,381,735
Cost of sales (except depreciation)			
Inventories 12/31/67			
Raw materials	2,810,000	R-2 (1967, 8)	2,960,464
Finished goods	2,560,000	R-2 (1967, 8)	2,659,840
Parts and supplies	570,000	R-2 (1967, 8)	600,521
Purchases	20,458,000	(1) 1.014	20,744,412
	26,398,000		26,965,237
Inventories 12/31/68			
Raw materials	2,540,000	R-2	2,575,560
Finished goods	2,390,000	R-2	2,390,000
Parts and supplies	612,000	R-2	620,568
	5,542,000		5,586,128
	20,856,000		21,379,109

(1) Spread fairly evenly throughout the year

XYZ COMPANY
General Price-Level Restatement—1968 12/31/68
Analysis of Expenses R-9

	Historical	Conversion factor or source	Restated to 12/31/68 $'s
Selling and administrative expenses			
Amortization of prepaid expenses	40,000	R-4	42,292
Other	2,580,000	(1) 1.014	2,616,120
	2,620,000		2,658,412

(1) Spread fairly evenly throughout the year

	Historical	Conversion factor or source	Restated to 12/31/68 $'s
Gain or (loss) on sale of equipment			
Cost	300,000	R-5	340,376
Accumulated depreciation	120,000	R-6	136,151
	180,000		204,225
Proceeds, June 1968	241,000	1.019	245,579
Gain	61,000		41,354
Gain or (loss) on sale of marketable securities			
Cost	1,500,000	R-2 (1967, 8)	1,718,600
Proceeds, December 1968	1,600,000	1.000	1,600,000
Gain (loss)	100,000		(118,600)

XYZ COMPANY
General Price-Level Restatement—1968
General Price-Level Gain or Loss

12/31/68
R-10

	Source	12/31/67 Historical	12/31/67 Restated to 12/31/68 $'s	12/31/68 Historical (stated in 12/31/68 $'s)
Net monetary items				
Cash	R-2	1,700,000	1,766,300	2,120,000
Receivables	R-2	5,050,000	5,246,950	6,170,000
Current liabilities	R-2	(4,770,000)	(4,956,030)	(2,521,000)
Long-term debt	R-2	(5,000,000)	(5,195,000)	(4,700,000)
		(3,020,000)	(3,137,780)	1,069,000

General price-level gain or loss	Historical	Source	Restated to 12/31/68 $'s
Net monetary items—12/31/67	(3,020,000)	as above	(3,137,780)
Add:			
Current sales	26,880,000	R-8	27,256,320
Additions to deferred income	70,000	R-7	71,070
Proceeds from sale of equipment	241,000	R-9	245,579
Proceeds from sale of securities	1,600,000	R-9	1,600,000
	25,771,000		26,035,189
Deduct:			
Purchases	20,458,000	R-8	20,744,412
Selling and administrative expenses—other	2,580,000	R-9	2,616,120
Federal income taxes	630,000	R-3	638,820
Dividends	200,000	R-3	201,900
Purchases of property, plant, and equipment	800,000	R-5	815,500
Additions to prepaid expenses	34,000	R-4	34,140
	24,702,000		25,050,892
Net monetary items—historical—12/31/68 (as above)	1,069,000		
Net monetary items—restated—12/31/68 (if there were no gain)			984,297
Net monetary items—12/31/68 (as above)			1,069,000
General price-level gain			84,703

APPENDIX D

GENERAL PRICE-LEVEL CHANGES AND SPECIFIC PRICE CHANGES

General price-level statements deal with changes in the general purchasing power of money. Adjustments for changes in the specific prices of nonmonetary assets and liabilities either by use of market prices or specific indexes, on the other hand, deal with changes in market or replacement values. Restatement for general price-level changes does not attempt to deal with specific market price changes; adjustments for specific price changes do not deal with the effects of inflation as such. The effects of general price-level changes and specific price changes may be dealt with separately or they may be dealt with simultaneously. Dealing with one is not a substitute for dealing with the other. Restatement for general price-level changes is appropriate if the effects of inflation are important, regardless of whether or not specific price changes are recognized currently. The effects of inflation are not treated if only specific price changes are recognized.

The following illustration shows the differences between recognition of general price-level changes and specific price changes.

Four different bases of accounting are illustrated:

1. Historical cost, not restated for general price-level changes.
2. Historical cost restated for general price-level changes (the method covered in this Statement).
3. Current value, not restated for general price-level changes.
4. Current value, restated for general price-level changes.

The illustration brings out the following points:

A. In the income statement

1. General price-level restatement changes the amounts but not the timing of revenue, expenses, gains, and losses.
2. Specific price adjustments (without general price-level restatement) change the timing of recognition of revenue, expenses, gains, and losses, but not the amounts.
3. Recognition of changes in both specific prices and in the general price level (1) changes the timing of recognition of revenue, expenses, gains, and losses and (2) changes the amounts.

B. In the balance sheet

1. General price-level accounting presents restated historical cost.
2. Specific price adjustments present assets at current market value or replacement cost or approximations of them.

Information for Illustration

Land was purchased in year 1 for $20,000. Market price did not change in year 1.

Land was held during year 2, during which market price advanced to $26,000.

Land was sold for $34,000 at the end of year 3.

GNP Deflator indexes:

Year 1	100
Year 2	110
Year 3	120

	Historical Cost		Current Value	
	Not restated (Col. 1)	Restated (Col. 2)	Not restated (Col. 3)	Restated (Col. 4)
Balance sheet amount of land				
End of year 1	$20,000	$20,000	$20,000	$20,000
End of year 2	$20,000	$22,000	$26,000	$26,000
Year 3 before sale	$20,000	$24,000	$34,000	$34,000
Income statement gains reported				
In year 1	$ –0–	$ –0–	$ –0–	$ –0–
In year 2	–0–	–0–	6,000	4,000(1)
In year 3	14,000	10,000	8,000	5,640(2)
Total gains for 3 years	$14,000	$10,000	$14,000	$10,000(3) (year 3 dollars)

Notes

(1) Market price, end of year 2 — $26,000

Restated market from year 1: 20,000 x 110/100 = — 22,000

Gain from appreciation — $ 4,000

(2) Selling price, year 3 — $34,000

Restated market from year 2: 26,000 x 120/110 = — 28,360

Gain from sale — $ 5,640

(3) The $4,000 gain in year 2 must be restated to year 3 dollars.
Total gain:

Year 2 appreciation— In year 2 dollars	$4,000	
In year 3 dollars	$4,000 x 120/110	$ 4,360
Year 3 sale		5,640
Total in year 3 dollars		$10,000

Comments

1. Column (1) is presented in accordance with present generally accepted accounting principles. Column (2) is presented in accordance with the recommendations of this Statement.

2. Columns (3) and (4) are not discussed in this Statement. They are presented for illustrative purposes only.

3. The restated historical cost balance sheet (column 2) preserves the cost basis. It does not result in presenting assets at market value or the recognition of unrealized gains or losses.

4. Restating the income statement for changes in the general price level changes the amount but not the timing of gains and losses. Recognizing current values changes the timing but not the amount of gains and losses in the income statement. Thus, in the illustration:

a. In the historical cost column (1 and 2), the timing of the gains is the same, but the amounts differ ($14,000 and $10,000).

b. In the current value columns (3 and 4), the timing of the gains is the same, but the amounts differ ($14,000 and $10,000).

c. In the unrestated columns (1 and 3), the total gain is the same ($14,000), but the timing and description of the gains are different.

d. In the restated columns (2 and 4), the total gain is the same ($10,000), but the timing and description of the gains are different.

APB Statement No. 4

BASIC CONCEPTS AND ACCOUNTING PRINCIPLES UNDERLYING FINANCIAL STATEMENTS OF BUSINESS ENTERPRISES

OCTOBER, 1970

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CHAPTER 1 Purpose and Nature of the Statement

PURPOSE OF THE STATEMENT

1. The American Institute of Certified Public Accountants through its Accounting Principles Board is engaged in a program of advancing the written expression of financial accounting principles for the purpose of increasing the usefulness of financial statements. The Board has been directed to devote its attention to the broad fundamentals of financial accounting as well as to specific accounting problems.[1] This Statement of basic concepts[2] and accounting principles underlying financial statements of business enterprises[3] states the Board's views in response to that directive.[4]

2. This Statement has two broad purposes, one educational and the other developmental. It is intended to provide a basis for enhanced understanding of the broad fundamentals of financial accounting. It is also intended to provide a basis for guiding the future development of financial accounting. To achieve these purposes the Statement (1) discusses the nature of financial accounting, the environmental forces that influence it, and the potential and limitations of financial accounting in providing useful information, (2) sets forth the objectives of financial accounting and financial statements, and (3) presents a description of present generally accepted accounting principles.

NATURE OF THE STATEMENT

3. The Statement is primarily descriptive, not prescriptive. It identifies and organizes ideas that for the most part are already accepted. In addition to the summary in Chapter 2, the Statement contains two main sections that are essentially distinct—(a) Chapters 3 to 5 on the environment, objectives, and basic features of financial accounting and (b) Chapters 6 to 8 on present generally accepted accounting principles. The description of present generally accepted accounting principles is based primarily on observation of accounting practice. Present generally accepted accounting principles have not been formally derived from the environment, objectives, and basic features of financial accounting.

4. The aspects of the environment selected for discussion are those that appear to influence the financial accounting process directly. The objectives of financial accounting and financial statements discussed are goals toward which efforts are presently directed. The accounting principles described are those that the Board believes are generally accepted *today. The Board has not evaluated or approved present generally accepted accounting principles except to the extent that principles have been adopted in Board Opinions. Publication of this Statement does not constitute approval by the Board of accounting principles that are not covered in its Opinions.*

5. Chapter 9 describes the dynamic nature of financial accounting and the need for continual reexamination of generally accepted accounting principles. The chapter describes how present generally accepted accounting principles may be evaluated on the basis of the material in the first section of the Statement (Chapters 3 to 5). The chapter also indicates some of the proposals that have been made for improving financial accounting information. These proposals,

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[1] See "Report to Council of the Special Committee on Research Program," *The Journal of Accountancy*, December 1958, pp. 62-68 and *Report of Special Committee on Opinions of Accounting Principles Board*, 1965, summarized in *The Journal of Accountancy*, June 1965, pp. 12, 14, and 16.

[2] The term *basic concepts* is used to refer to the observations concerning the environment, the objectives of financial accounting and financial statements, and the basic features and basic elements of financial accounting discussed in Chapters 3-5 of the Statement.

[3] See paragraph 51 for a discussion of business enterprises. Although this Statement applies to business enterprises, some of the contents may also apply to not-for-profit organizations.

[4] Three accounting research studies were among the sources used in preparing this Statement: Accounting Research Study No. 1, *The Basic Postulates of Accounting*, by Maurice Moonitz; Accounting Research Study No. 3, *A Tentative Set of Broad Accounting Principles for Business Enterprises*, by Robert T. Sprouse and Maurice Moonitz; and Accounting Research Study No. 7, *Inventory of Generally Accepted Accounting Principles for Business Enterprises*, by Paul Grady. (Accounting research studies are not pronouncements of this Board or of the Institute, but are published for the purpose of stimulating discussion on important accounting issues.)

which the Board has not evaluated, may also be evaluated on the basis of the material in the first section of the Statement.

6. The Statement is a step toward development of a more consistent and comprehensive structure of financial accounting and of more useful financial information. It is intended to provide a framework within which the problems of financial accounting may be solved, although it does not propose solutions to those problems and does not attempt to indicate what generally accepted accounting principles should be. Evaluation of present accounting principles and determination of changes that may be desirable are left to future pronouncements of the Board.

7. The status of Statements of the Board is defined in the note following paragraph 219. This Statement does not change, supersede, or interpret Accounting Research Bulletins or Opinions of the Accounting Principles Board currently in effect. The normal procedures established to maintain the effectiveness of these pronouncements and to interpret them continue in effect unchanged. The Statement does, however, modify some of the definitions of technical accounting terms in the Accounting Terminology Bulletins.[8] The following sections are superseded:

Accounting Terminology Bulletin No. 1, paragraphs:

9—*accounting*
21—*balance sheet*
26—*assets*
27—*liabilities*

Accounting Terminology Bulletin No. 4, paragraph 2, *cost*.

The following sections are amended:

Accounting Terminology Bulletin No. 2, paragraphs:

5—*revenue*
8—*income*

Accounting Terminology Bulletin No. 4, paragraph 3, *expense*.

These changes are noted by footnotes at appropriate places in the Statement.

TERMINOLOGY

8. Technical language is used in financial accounting. Many technical terms used in financial accounting are words that have wide common usage but that are given special meanings by accountants. Many important technical terms are defined or discussed in this Statement. The meaning of these terms is best understood in the context of the discussions in which they appear. The terms and the paragraphs in which they are defined or discussed are:

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Accounting	40
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Basic elements	130
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Fair value	145 (footnote 42), 181 [M-1A(1)]
Financial accounting	41
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General objectives	73, 76
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Income statement	12, 135
Internal events	62
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Matching	147 (footnote 43)
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[8] The Accounting Terminology Bulletins do not have the same authoritative status as the Accounting Research Bulletins and the Opinions of the Accounting Principles Board but are useful guides to financial accounting terminology.

	Paragraph Numbers
Net realizable value	70 (footnote 17)
Nonreciprocal transfers	62
Owners' equity	132
Production	49, 62
Profit-directed activities	78 (footnote 21)
Qualitative objectives	85, 86
Realization	150
Residual interest	59
Results of operations	135
Retained earnings	198
Revenue	134, 148
Statement of retained earnings	13
Substantial authoritative support	137 (footnote 38)
Transfers between the enterprise and its owners	62
Working capital	198

CHAPTER 2 Summary of the Statement

9. Accounting is a service activity. Its function is to provide quantitative information, primarily financial in nature, about economic entities that is intended to be useful in making economic decisions. This Statement deals with financial accounting for business enterprises, the branch of accounting that focuses on the general-purpose reports on financial position and results of operations known as financial statements.

FINANCIAL STATEMENTS

10. Financial statements are the means by which the information accumulated and processed in financial accounting is periodically communicated to those who use it. They are designed to serve the needs of a variety of users, particularly owners and creditors. Through the financial accounting process, the myriad and complex effects of the economic activities of an enterprise are accumulated, analyzed, quantified, classified, recorded, summarized, and reported as information of two basic types: (1) financial position, which relates to a point in time, and (2) changes in financial position, which relate to a period of time. Notes to the statements, which may explain headings, captions, or amounts in the statements or present information that cannot be expressed in money terms, are an integral part of the statements.

Financial Position—The Balance Sheet

11. A balance sheet (or statement of financial position) presents three major categories: (a) assets, (b) liabilities, and (c) owners' equity, the difference between total assets and total liabilities. A balance sheet at any date presents an indication in conformity with generally accepted accounting principles of the financial status of the enterprise at a particular point of time.

Changes in Financial Position—The Income Statement

12. The income statement for a period presents the revenue, expenses, gains, losses, and net income (net loss) recognized during the period and thereby presents an indication in conformity with generally accepted accounting principles of the results of the enterprise's profit-directed activities during the period. The information presented in an income statement is usually considered the most important information provided by financial accounting because profitability is a paramount concern to those interested in the economic activities of the enterprise.

Changes in Financial Position—Changes in Owners' Equity

13. An income statement is usually not sufficient to describe the total change in owners' equity during a period because changes arise from sources other than profit-directed activities. The total change in owners' equity is described by three statements: an income statement, a statement of retained earnings, and a statement of other changes in owners' equity. A statement of retained earnings presents net income (as shown in the income statement) and items such as dividends and adjustments of the net income of prior periods. A statement of other changes in owners'

equity presents additional investments by owners, retirements of owners' interests (except for the part considered to be a distribution of earnings), and similar events. If these other changes are simple and few in number, they are often presented in notes to the other financial statements rather than in a separate statement.

Changes in Financial Position—Other Statements

14. A statement of source and application of funds is frequently presented. It shows the major sources of increases in an enterprise's assets for a period in addition to net income, for example, from borrowing, owners' investments, and disposal of assets other than through normal operations. It also shows how the enterprise used its assets during the period, for example, in acquiring other assets, in paying debt, and in distributions to owners. This statement has other names, including *statement of working capital changes* and *statement of source and use of funds.*

15. Statements that analyze specific changes in financial position are occasionally presented, for example, changes in plant and equipment, changes in long-term liabilities, and cash receipts and disbursements. Statements that analyze changes in each asset, each liability, and each item of owners' equity could be prepared, but statements of changes in financial position in addition to those already discussed are seldom presented.

The Source of Financial Statements

16. Financial statements are the end product of the financial accounting process. This process is governed by generally accepted accounting principles, which determine the information that is included, how it is organized, measured, combined, and adjusted, and finally how it is presented in the financial statements. The principles reflect the objectives and the basic features of financial accounting (discussed below). All of financial accounting—principles, objectives, and basic features—is grounded in the environment of business enterprises.

THE ENVIRONMENT OF FINANCIAL ACCOUNTING

17. An understanding of financial accounting and an ability to evaluate the information it produces depend not only on delineation of accounting principles and the features and objectives of accounting, but also on an understanding of the environment within which financial accounting operates and which it is intended to reflect (Chapter 3). The users of financial accounting information and economic activity in society and in individual business enterprises are aspects of the environment important to an analysis of the problems of financial accounting.

Users

18. Needs and expectations of users of financial statements are a part of the environment that determines the type of information required of financial accounting. A knowledge of important classes of users, of their common and special needs for information, and of their decision processes is helpful in improving financial accounting information.

Economic Activity

19. Economic activity can be described in terms of (1) its general nature in highly developed economies, (2) the economic resources, obligations, and residual interest of a business enterprise and the economic activities that change them, and (3) the ways of measuring economic activity.

20. Describing economic resources, economic obligations, and residual interest and the economic activities that change them is important because the basic elements of financial accounting—assets, liabilities, owners' equity, revenue, expenses, and net income—are related to these economic elements. A discussion of the measurement of economic activity is also relevant because measurement difficulties underlie many of the problems of financial accounting.

OBJECTIVES OF FINANCIAL ACCOUNTING AND FINANCIAL STATEMENTS

21. The basic purpose of financial accounting and financial statements is to provide financial information about individual business enterprises that is useful in making economic decisions (Chapter 4). General and qualitative objectives aid in fulfilling this basic purpose and provide means for evaluating present and proposed accounting principles.

22. General objectives determine the appropriate content of financial accounting information. These objectives are to pre-

sent reliable financial information about enterprise resources and obligations, economic progress, and other changes in resources and obligations, to present information helpful in estimating earnings potential, and to present other financial information needed by users, particularly owners and creditors.

23. Certain qualities or characteristics make financial information useful. Providing information that has each of these qualities is an objective of financial accounting. These qualitative objectives are relevance, understandability, verifiability, neutrality, timeliness, comparability, and completeness.

24. The objectives of financial accounting and financial statements are at least partially achieved at present, although improvement is probably possible in connection with each of them. Constraints on full achievement of the objectives arise from (1) conflicts of objectives, (2) environmental influences, and (3) lack of complete understanding of the objectives.

BASIC FEATURES AND BASIC ELEMENTS OF FINANCIAL ACCOUNTING

Basic Features

25. The basic features of financial accounting (Chapter 5) are determined by the characteristics of the environment in which financial accounting operates. The features are:

(1) *Accounting entity*—economic activities of individual entities are the focus of financial accounting.

(2) *Going concern*—continuation of entity operations is usually assumed in financial accounting in the absence of evidence to the contrary.

(3) *Measurement of economic resources and obligations*—financial accounting is primarily concerned with measurement of economic resources and obligations and changes in them.

(4) *Time periods*—financial accounting presents information about activities for relatively short time periods.

(5) *Measurement in terms of money*—financial accounting measures in terms of money.

(6) *Accrual*—determining periodic income and financial position depends on measurement of noncash resources and obligations.

(7) *Exchange price*—financial accounting measurements are primarily based on exchange prices.

(8) *Approximation*—approximations are inevitable in the allocations required in financial accounting.

(9) *Judgment*—financial accounting requires informed judgment.

(10) *General-purpose financial information*—financial accounting presents general-purpose financial information.

(11) *Fundamentally related financial statements*—statements of financial position and changes in financial position are fundamentally related.

(12) *Substance over form*—financial accounting emphasizes the economic substance of events even though the legal form may differ from the economic substance and suggest different treatment.

(13) *Materiality*—financial reporting is only concerned with significant information.

Basic Elements

26. The basic elements of financial accounting are assets, liabilities, owners' equity, revenue, expenses, and net income (Chapter 5). These elements are defined in terms of (a) economic resources, economic obligations, and residual interest and changes in resources, obligations, and residual interest and (b) generally accepted accounting principles.

GENERALLY ACCEPTED ACCOUNTING PRINCIPLES

27. Generally accepted accounting principles (Chapters 6 to 8) incorporate the consensus* at any time as to which economic resources and obligations should be recorded as assets and liabilities, which changes in them should be recorded, when these changes should be recorded, how the recorded assets and liabilities and changes in them should be measured, what information should be disclosed and how it should be disclosed, and which financial statements should be prepared. In this Statement, generally accepted accounting principles are divided into three levels: pervasive principles, broad operating principles, and detailed principles.

* See paragraph 137, footnote 38.

28. Pervasive principles (Chapter 6) form the basis for much of the accounting process. They include pervasive measurement principles and modifying conventions. The pervasive measurement principles—for example, realization—broadly determine the events recognized in financial accounting, the basis of measurement used in financial accounting, and the way net income is determined. The modifying conventions—for example, conservatism—affect the application of the pervasive measurement principles.

29. Broad operating principles (Chapter 7) are general rules, derived from the pervasive principles, that govern the application of the detailed principles. They are described in this Statement in two groups, principles of selection and measurement and principles of financial statement presentation. The principles of selection and measurement include principles that guide selection of events to be accounted for and assignment of dollar amounts and principles that determine the effects of recorded events on assets, liabilities, owners' equity, revenue, and expenses of the enterprise.

30. Detailed principles are the numerous rules and procedures that are based on the broad principles and specify the way data are processed and presented in specific situations. Detailed principles are discussed but not listed in Chapter 8.

31. The three types of principles determine the operation of the financial accounting process. All three levels of principles are conventional. They have developed on the basis of experience, reason, and custom; they become generally accepted by agreement (often tacit agreement) and are not formally derived from a set of postulates.

DYNAMIC NATURE OF FINANCIAL ACCOUNTING

32. Present generally accepted accounting principles are the result of an evolutionary process that can be expected to continue (Chapter 9). Principles change in response to changes in economic and social conditions, to new knowledge and technology, and to demands by users for more serviceable financial information. Change is more pronounced in the detailed principles than in the broad operating principles; the pervasive principles tend to be the most stable. Nevertheless, because the principles are conventional and have been developed in relation to a specific environment and with assumptions about needed financial information, they are all subject to review, evaluation, and possible change.

CHARACTERISTICS AND LIMITATIONS OF FINANCIAL ACCOUNTING AND FINANCIAL STATEMENTS

33. The environment, objectives, and basic features of financial accounting determine the structure of financial accounting and provide constraints and conditions on its operations. The accounting principles that are generally accepted at a particular time as the basis of reporting represent a response to these influences, constraints, and conditions as they exist at that time and determine not only the scope of financial accounting information at that time but also its relevance. These principles are the result of the historical development of financial accounting, the way in which needs of users of financial accounting information are perceived, and the way accountants interact with the environment.

34. The complexity of the economic activity that forms the subject matter of accounting gives financial accounting some definite limits. Taking one approach in financial accounting requires rejection of other approaches and limits the scope of accounting. The approach taken is reflected in certain characteristics of the financial accounting process and its product, the financial statements. In the midst of the continuous and complex interactions found in the economic environment of enterprises, periodic measurements are made based on a relatively simple classification system. Faced with the uncertainty and joint effects that characterize economic activity, accountants adopt conventional procedures that emphasize verifiable measures and are based on assumptions that certain causal relationships exist and can be traced.

35. Some of the more important present characteristics and limitations of financial accounting and financial statements are briefly described.

Historical Report. Financial accounting and financial statements are primarily historical in that information about events that have taken place provides the basic data of financial accounting and financial statements.

General-Purpose Financial Statements. Financial accounting presents information designed to serve the common needs of a variety of user groups with primary emphasis on the needs of present and potential owners and creditors.

Fundamentally Related Financial Statements. Financial statements are fundamentally related. Aspects of financial position presented in the balance sheet are related to changes in financial position presented in the income statement.

Classification. Information about financial position and results of operations is classified based on the presumed needs of owners, creditors, and other users.

Summarization. Transactions and other events of a business enterprise that have similar characteristics are grouped and presented in summary form.

Measurement in Terms of Money. Financial statements in the United States are expressed in terms of numbers of U. S. dollars. Changes in the general purchasing power of the dollar are not reflected in the basic financial statements.

Measurement Bases. Several measurement bases are used in financial accounting, for example, net realizable value (receivables), lower of acquisition cost and present market price (inventories), and acquisition cost less accumulated depreciation (plant and equipment). Financial statements in general do not purport to reflect the current value of the assets of the enterprise or their potential proceeds on liquidation under present generally accepted accounting principles.

Accrual. The effects of transactions and other events on the assets and liabilities of a business enterprise are recognized and reported in the time periods to which they relate rather than only when cash is received or paid.

Estimates and Judgment. The complexity and uncertainty of economic activity seldom permit exact measurement. Estimates and informed judgment must often be used to assign dollar amounts to the effects of transactions and other events that affect a business enterprise.

Verifiability. Although estimates are unavoidable in financial accounting, an attempt is made to keep the effects of estimates to a minimum by basing financial accounting measurements primarily on enterprise transactions and requiring corroboration by outside evidence before increases in value are recognized. Estimates included in financial accounting are usually related in some way to data derived from verifiable events and the estimates are accounted for in a consistent and systematic manner.

Conservatism. The uncertainties that surround the preparation of financial statements are reflected in a general tendency toward early recognition of unfavorable events and minimization of the amount of net assets and net income.

Substance Over Form. Although financial accounting is concerned with both the legal and economic effects of transactions and other events and many of its conventions are based on legal rules, the economic substance of transactions and other events are usually emphasized when economic substance differs from legal form.

Technical Terminology. Many of the terms used in financial statements are common words to which accountants have given technical meanings.

Audience. Financial statement users are presumed to be generally familiar with business practices, the technical language of accounting, and the nature of the information reported.

USE OF FINANCIAL ACCOUNTING INFORMATION

36. Appropriate use of financial accounting information requires a knowledge of the characteristics and limitations of financial accounting. Financial accounting information is produced for certain purposes by the use of conventional principles. Use of the information for other purposes or without a general knowledge of its characteristics and limitations may lead to misinterpretation and errors.

37. An important characteristic of financial statements, for example, is that the information they contain describes the past, while decision making is oriented toward the future. A record of past events and a knowledge of past position and changes in position, however, help users evaluate prior decisions and this information is also a starting point for users in predicting the future. Decision makers should not assume, however, that the conditions that produced past results will necessarily continue in the future.

38. Financial statements are designed to provide an important part of the information that users need for many of their decisions. The information contained in the statements should not be relied on exclusively, however, and should be supplemented by other information about the specific prospects of the company, the industry in which it operates, and the economy in general.

39. A knowledge of the characteristics and limitations of financial statements also helps users avoid putting undue reliance on single measures or the results of a single year. Net income or earnings per share of a single year, for example, should not be overemphasized since these amounts are derived from complex computations, are based on estimates and judgments, and often have their meaning modified by information in the notes to the financial statements. In reaching decisions users should consider movements in the components of net income, the effects of estimates and judgments, the possible effects of information disclosed in notes, and similar factors.

CHAPTER 3

The Environment of Financial Accounting

40. Accounting is a service activity. Its function is to provide quantitative information, primarily financial in nature, about economic entities that is intended to be useful in making economic decisions—in making reasoned choices among alternative courses of action. Accounting includes several branches, for example, financial accounting, managerial accounting, and governmental accounting.

41. Financial accounting for business enterprises is one branch of accounting. It provides, within limitations described below, a continual history quantified in money terms of economic resources and obligations of a business enterprise and of economic activities that change those resources and obligations.

42. Financial accounting is shaped to a significant extent by the environment, especially by:

1. The many uses and users which it serves,

2. The overall organization of economic activity in society,

3. The nature of economic activity in individual business enterprises, and

4. The means of measuring economic activity.

Environmental conditions, restraints, and influences are generally beyond the direct control of businessmen, accountants, and statement users. Understanding and evaluating financial accounting requires knowledge of this environment and of its impact on the financial accounting process. Aspects of the environment are reflected in the basic features and basic elements of financial accounting (see Chapter 5) and in generally accepted accounting principles (see Chapters 6 to 8).

USES AND USERS OF FINANCIAL ACCOUNTING INFORMATION

43. Financial accounting information[7] is used by a variety of groups and for diverse purposes. The needs and expectations of users determine the type of information required. User groups may be broadly classified into (1) those with direct interests in business enterprises and (2) those with indirect interests.

Users with Direct Interests

44. Some users have or contemplate having a direct economic interest in business enterprises. Examples of these users and of the types of evaluations and decisions for which they use financial accounting information are:

Owners—retain, increase, or decrease proportionate ownership; evaluate the use and stewardship of resources by management.

Creditors and suppliers—extend credit; determine terms of credit; require security or restrictive covenants in terms; enter suit or force bankruptcy or receivership; increase or decrease reliance on the enterprise as a customer.

Potential owners, creditors, and suppliers—commit resources to the enterprise; de-

[7] The term *information* is sometimes applied only to relevant data. This Statement does not distinguish between the terms *information* and *data*.

termine amount of commitment; evaluate the use and stewardship of resources by management.

Management (including directors and officers)—assess nature and extent of financing needs; evaluate results of past economic decisions; set dividend policy; project future financial position and income; assess merger and acquisition possibilities; recommend reorganization or dissolution.

Taxing authorities—evaluate tax returns; assess taxes or penalties; make investigations and audits.

Empolyees—negotiate wages; terminate employment; or, for prospective employees, apply for employment.

Customers—anticipate price changes; seek alternative sources or broader bases of supply.

Users with Indirect Interests

45. Some users of financial accounting information derive an interest because their function is to assist or protect those who have or contemplate having a direct interest. Examples are:

Financial analysts and advisors—advise investors and potential investors to retain, increase, decrease, or acquire an investment in the enterprise; evaluate prospects of investment in the enterprise relative to alternative investments.[8]

Stock exchanges—accept or cancel listings; suspend trading; encourage changes in accounting practices or additional disclosure of information.

Lawyers—determine whether covenants and contractual provisions are fulfilled; advise on legality of dividends and profit sharing and deferred compensation agreements; draft pension plan terms.

Regulatory or registration authorities—assess reasonableness of rate of return; allow or require increases or decreases in prices or rates; require or recommend changes in accounting or disclosure practices; issue cease-and-desist or stock-trading-suspension orders.

Financial press and reporting agencies—prepare descriptive analyses; combine, summarize, or select information to present in descriptions; conform information to uniform presentation arrangements; compute trends and ratios.

Trade associations—compile industry statistics and make comparisons; analyze industry results.

Labor unions—formulate wage and contract demands; assess enterprise and industry prospects and strengths.

Common and Special Needs

46. Financial accounting information may be directed toward the common needs of one or more of the user groups cited above or may be directed toward specialized needs. Examples of information directed toward common needs are the general-purpose reports on enterprise financial position and progress known as the balance sheet and the income statement. The emphasis in financial accounting on general-purpose information (see paragraph 125) is based on the presumption that a significant number of users need similar information. General-purpose information is not intended to satisfy specialized needs of individual users.

47. Examples of information that is derived from financial accounting records and directed toward specialized needs are some financial reports submitted to regulatory authorities, special financial reports prepared to obtain credit or loans, many reports to management, tax returns, and statistical financial information given to trade and industry associations. Information prepared for a particular purpose cannot be expected to serve other needs well. Furthermore, the problem of ascertaining specialized needs of a large number of users, the cost of attempting to serve these needs on an individual basis, and the confusion that might result from disseminating more than one set of information about the financial results of an enterprise's operation militate against attempting to serve all needs of users with special-purpose reports.

48. Improving financial accounting requires continuing research on the nature of user needs, on the decision processes of users, and on the information that most effectively serves user needs.

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[8] Investment bankers are users with derived interests when they act as analysts and advisors to issuers of securities and investors in securities. They are users with direct interests when they purchase and sell securities on their own account.

THE ORGANIZATION OF ECONOMIC ACTIVITY IN SOCIETY

49. All societies engage in certain fundamental economic activities:

Production—the process of converting economic resources into outputs of goods and services that are intended to have greater utility than the required inputs. In this Statement the term *production* is used in this broad sense and encompasses the provision of services and the movement and storage of goods as well as changes in physical form of goods. The term *production* therefore is not used in this Statement synonymously with the term *manufacturing*.[*]

Income distribution—the process of allocating rights to the use of output among individuals and groups in society.

Exchange—the process of trading resources or obligations for other resources or obligations.

Consumption—the process of using the final output of the production process.

Saving—the process by which individuals and groups set aside rights to present consumption in exchange for rights to future consumption.

Investment—the process of using current inputs to increase the stock of resources available for future output as opposed to immediately consumable output.

50. In less developed economies each form of economic activity is relatively simple and many of the processes are merged into one another. Individuals or groups produce for their own consumption; the distribution of claims to output and income is direct and obvious; exchange is the exception rather than the rule; and saving and investment occur together as some individuals or groups set aside part of the product of their current effort for future rather than present consumption.

51. In contrast, economic activity is specialized and complex in highly developed economies like the United States. Goods and services are produced by specialized units. These units may be government owned, but in the United States most productive activity is carried on through investor owned business enterprises. Business enterprises are individuals or associations of individuals that control and use resources for a variety of purposes including the purpose of yielding a return to the owners of the enterprise. They produce for sale rather than their own consumption and generally engage in market exchanges to acquire inputs for the production process and to dispose of goods and services produced.

52. Within producing units, the production process itself is often specialized and complex. Modern organization permits and modern technology requires long, continuous, and intricate processes in which products and services are often the joint result of several productive resources. Rapid changes in technology change patterns of inputs and of outputs and contribute to changes in their relative prices. Likewise, shifts in consumer demands and preferences affect the prices of outputs and through these the prices of inputs used in the production process.

53. Savings and investment are also separate, specialized activities. Savings are invested through a complex set of intermediaries which offer the saver diverse types of ownership or creditor claims, most of which can be freely traded.

54. The complexity and diversity of modern economic organization have implications for financial accounting:

(1) Since economic activity of business enterprises tends to be continuous, relationships associated with intervals of time like a year or a quarter of a year can be measured only on the basis of assumptions or conventional allocations.

(2) Because of the complexity of modern production and the joint nature of economic results, the relative effects of the various productive resources are intertwined, not only with each other but with external market events. Computing the precise effects of a particular input unit or a particular external event is therefore impossible except on an arbitrary basis.

(3) In a dynamic economy, the outcome of economic activity is uncertain at the time decisions are made and financial results often do not correspond to original expectations.

55. On the other hand, certain elements of modern economic organization help to provide an underlying continuity and stability to some aspects of economic activity and hence to the task of measuring that activity. In particular:

[*] See paragraph 62 for further discussion of production.

(1) Several forms of enterprise, especially the corporate form, continue to exist as legal entities for extended periods of time.

(2) The framework of law, custom, and traditional patterns of action provides a significant degree of stability to many aspects of the economic environment. In a society in which property rights are protected, contracts fulfilled, debts paid, and credit banking and transfer operations efficiently performed, the degree of uncertainty is reduced and the predictability of the outcome of many types of economic activities is correspondingly increased.

ECONOMIC ACTIVITY IN INDIVIDUAL BUSINESS ENTERPRISES

56. The economic activities of a business enterprise increase or decrease (1) its economic resources, (2) its economic obligations, and (3) the residual interest in its resources.

Economic Resources

57. Economic resources are the scarce means (limited in supply relative to desired uses) available for carrying on economic activities. The economic resources of a business enterprise include:

1. *Productive resources*

These resources are the means used by the enterprise to produce its product:

a. Productive resources of the enterprise—

These include raw materials, plant, equipment, natural resource deposits, patents and similar intangibles, goodwill, services, and other resources used in production.

b. Contractual rights to productive resources—

These include contractual rights to the use of resources of other entities (including individuals) as well as rights to delivery of materials, plant, and equipment from other entities. Contractual rights to resources of other entities often arise in mutual commitments in which payment is to be made as, or shortly after, the goods or services are used or received.

2. *Products*

These resources are outputs of the enterprise, consisting of (a) goods awaiting exchange, and (b) partially completed goods still in the process of production.[10]

3. *Money*

4. *Claims to receive money*

5. *Ownership interests in other enterprises.*

Economic Obligations

58. The economic obligations of an enterprise at any time are its present responsibilities to transfer economic resources or provide services to other entities in the future. Obligations usually arise because the enterprise has received resources from other entities through purchases or borrowings. Some obligations, however, arise by other means, for example, through the imposition of taxes or through legal action. Obligations are general claims against the enterprise rather than claims to specific resources of the enterprise unless the terms of the obligation or applicable legal rules provide otherwise. Economic obligations include:

1. *Obligations to pay money*
2. *Obligations to provide goods or services*

These are normally contractual obligations calling for the transfer of resources other than money according to specified conditions. The obligations may arise because payment for the goods or services to be provided has already been received or as the result of a mutual commitment.

Residual Interest

59. The residual or owners' interest is the interest in the economic resources of an enterprise that remains after deducting economic obligations. It is the interest of those who bear the ultimate risks and uncertainties and receive the ultimate benefits of enterprise operations. At the start of the enterprise the residual interest equals the owners' initial investment of resources. Increases or decreases in enterprise resources that are not offset by equal changes in enterprise obligations change the residual interest.

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[10] The products of an enterprise also include services provided to other entities. Services provided to others cannot be inventoried, however, and therefore are not resources of the enterprise.

Relationship Among Economic Resources, Economic Obligations, and Residual Interest

60. The relationship among the resources of an enterprise and the claims and interests in those resources implicit in the definition of residual interest is:

Economic Resources − Economic Obligations = Residual Interest [11]

The resources, obligations, and residual interest of an enterprise are the basis for the basic elements of financial position—assets, liabilities, and owners' equity—dealt with in financial accounting (see paragraphs 132 and 133).

Changes in Economic Resources, Economic Obligations, and Residual Interest

61. Resources, obligations, and residual interest of an enterprise change over time. Changes in resources and obligations include acquisitions and dispositions of resources, incurrence and discharge of obligations, and changes in the utility or prices of resources held. Because resources, obligations, and residual interest are related, changes in them are also related and a change in total resources is always accompanied by a change in obligations or residual interest. Events that change resources, obligations, and residual interest are the basis for the basic elements of results of operations—revenue, expenses, and net income (see paragraphs 134 and 135)—and other changes in financial position with which financial accounting is concerned.

62. Events that change the resources, obligations, or residual interest of an enterprise may be classified in many ways. The following classification is intended to be complete, to avoid overlapping, and to highlight differences that are important to financial accounting. This classification of events is used in Chapter 7 of this Statement as the basis for presenting the principles of selection and measurement.

I. External events: events that affect the enterprise and in which other entities participate.

A. Transfers of resources or obligations to or from other entities.

1. Exchanges—

These events are reciprocal transfers of resources or obligations between the enterprise and other entities in which the enterprise either sacrifices resources or incurs obligations in order to obtain other resources or satisfy other obligations. Exchanges occur if each party to the transaction values that which he will receive more than that which he must give up and if the particular exchange is evaluated as preferable to alternative actions. Exchanges encompass many of the economic interactions of entities; they include contractual commitments as well as transfers of goods, services, money, and the exchange of one obligation for another. Some exchanges take place on a continuous basis over time instead of being consummated at a moment of time—for example, accumulations of interest and rent.

2. Nonreciprocal transfers—

These events are transfers in one direction of resources or obligations, either from the enterprise to other entities or from other entities to the enterprise.

a. Transfers between the enterprise and its owners—

These are events in which the enterprise receives resources from owners and the enterprise acknowledges an increased ownership interest, or the enterprise transfers resources to owners and their interest decreases.[12] These transfers are not exchanges from the point of view of the enterprise. The enterprise sacrifices none of its resources and incurs no obligations in exchange for owners' investments, and it receives nothing of value to itself in exchange for the resources it distributes.[13] Transfers of this type also include declaration of dividends and substituting ownership interest for obligations.

b. Nonreciprocal transfers between the enterprise and entities other than owners—

[11] Expressing the relationship in a mathematical equation goes beyond descriptions of terms and assumes appropriate measurement. Measurement of economic activity is discussed in paragraphs 66-72.

[12] Interactions of enterprises with owners acting as customers, suppliers, employees, debtors, creditors, donors, etc., rather than as owners are excluded from this category.

[13] The distinction between exchanges and transfers between an enterprise and its owners is important in financial accounting today because resources are normally recorded at the cost (see paragraph 164) in an exchange; owners' investments have no cost to the enterprise and are recorded at the fair value of the assets received (see paragraph 182, M-2). Furthermore, revenue and expenses can result from exchanges but not from transfers between an enterprise and its owners.

In these transfers one of the two entities is often passive, a mere beneficiary or victim of the other's actions. Examples are gifts, dividends received, taxes, loss of a negligence lawsuit, imposition of fines, and theft.

B. External events other than transfers of resources or obligations to or from other entities.

Enterprise resources may be changed by actions of other entities that do not involve transfers of enterprise resources or obligations. Examples are changes in specific prices of enterprise resources, changes in interest rates, general price-level changes, technological changes caused by outside entities, and vandalism. In addition to their direct effects on the enterprise, these types of events also introduce an element of uncertainty into production and exchange activities. Unfavorable effects of these events may at best be insured or hedged against or provided for through policies that promote orderly adaptation to changed conditions.

II. Internal events: events in which only the enterprise participates.

A. Production.

Production in a broad sense is the process by which resources are combined or transformed into products (goods or services). Production does not necessarily alter the physical form of the items produced; it may involve simply a change in location or the holding of items over a period of time. Production encompasses a broad range of activities, including manufacturing, exploration, research and development, mining, agriculture, transportation, storage, marketing and distribution, merchandising, and provision of services. Each of these activities is intended to result in a product with an exchange price greater than the cost of the resources used in its production. Production includes all the internal events of an enterprise except casualties. (The term *production* therefore is *not* used in this Statement synonymously with the term *manufacturing*.)

B. Casualties.

Casualties are sudden,[14] substantial, unanticipated reductions in enterprise resources not caused by other entities.[15] Examples are fires, floods, and other events ordinarily termed acts of God. Some events in this category are similar to those in category IB in that they introduce an element of uncertainty and may be insured against.

63. Net income or loss can result from each of the types of events listed except transfers between an enterprise and its owners.

64. *Discussion of Classification of Events.* Classifying events involves problems regardless of the system of classification chosen. First, the distinctions between classes probably cannot be made clear enough to make the class in which every event belongs obvious. For example, the distinctions between external and internal events and between production and casualties involve borderline situations which require judgment in assigning events to classes. Second, more than one event can occur at the same time and place. For example, when employees are at work, exchanges are taking place between the enterprise and the employees (wages and salaries are accruing) and production is taking place at the same time. Single occurrences must sometimes be analyzed into component events that fit into separate classes. Finally, the economic substance of some events may differ from their legal form. Classification of this kind of event may differ depending on whether its form or its substance is considered to govern (see paragraph 127).

65. *Cost.* Changes in resources, obligations, and residual interest often involve economic cost to the enterprise. Economic cost is the sacrifice (that which is given up or foregone) incurred in economic activities (see paragraph 164 for treatment of cost under generally accepted accounting principles).

MEASURING ECONOMIC ACTIVITY

66. Comparison and evaluation of diverse economic activities are facilitated by measurement[16] of enterprises' resources and obligations and the events that change them.

[14] Casualties also include concealed progressive changes in assets that are discovered after substantial change has taken place, for example, damage from settling of a building foundation.

[15] This definition of casualties differs from that in the Internal Revenue Code, which includes some external events as casualties.

[16] The terms *measurement* and *valuation* are often used interchangeably in accounting to mean simply the quantification of resources, obligations, and changes in them in money terms. An accounting research study on measurement and valuation in financial accounting is now in progress. The technicalities of differences between measurement and valuation, if any, will be examined in that study.

Measurement Problems

67. The complexity, continuity, and joint nature of economic activity (see paragraphs 51 to 54) present problems in measuring the effects of enterprise activities and associating them with specific products and services and with relatively short time periods. The need to relate measurements to each other also presents problems because it requires selecting like quantitative attributes and ignoring others. Attributes are selected on the basis of concepts that specify the attribute to be measured and how and when measurements are to be made. Disagreements over measurement concepts are the source of many of the differences of opinion about how to achieve the objectives of financial accounting and financial statements. (The objectives are discussed in Chapter 4.)

68. Because the resources and obligations of an enterprise and changes in them are inseparably connected, measuring the resources and obligations and measuring changes in them (including those changes that are the source of net income for a period) are two aspects of the same problem.

Exchange Prices

69. The effects of economic activities are measured in terms of money in a monetary economy. Money measurements are used to relate economic activities that use diverse types of resources to produce diverse types of products and services. Fluctuations in the general purchasing power of money cause problems in using money as a unit of measure (see paragraphs 166 to 168 in Chapter 6).

70. Resources are measured in terms of money through money prices, which are ratios at which money and other resources are or may be exchanged. Several types of money prices can be distinguished based on types of markets (purchase prices and sales prices) and based on time (past prices, present prices, and expected future prices). Four types of money prices are used in measuring resources in financial accounting.

1. *Price in past purchase exchanges of the enterprise*

This price is usually identified as *historical cost* or *acquisition cost* because the amount ascribed to the resource is its cost, measured by the money or other resources exchanged by the enterprise to obtain it.

2. *Price in a current purchase exchange*

This price is usually identified as *replacement cost* because the amount ascribed to the resource is measured by the current purchase price of similar resources that would now have to be paid to acquire it if it were not already held or the price that would now have to be paid to replace assets held.

3. *Price in a current sale exchange*

This price is usually identified as *current selling price* because the amount ascribed to the resource is measured by the current selling price of the resource that would be received in a current exchange.

4. *Price based on future exchanges*

This price is used in several related concepts—*present value of future net money receipts, discounted cash flow, (discounted) net realizable value,* and *value in use.* Each indicates that the amount ascribed to the resource is measured by the expected net future money flow related to the resource in its present or expected use by the enterprise, discounted for an interest factor.[17]

71. Each of these concepts has at least some current application in financial accounting. Their application is discussed in connection with present generally accepted accounting principles in Chapter 7, paragraph 179.

72. Measuring economic activities in terms of exchange prices has certain limitations because some important changes that affect these activities are not changes in monetary attributes of resources. Examples are (1) physical changes in resources during production, (2) certain external events, such as technological changes and changes in consumer tastes, and (3) certain broad forces in the economy, such as changes in governmental attitudes toward business operations. Reporting these changes in terms of exchange prices when they occur requires certain assumptions, for example, assumptions concerning the presumed effect of these changes on prices of enterprise resources. The alternative is to wait to report these changes until they affect aspects of resources that are directly related to exchange prices or until exchanges occur.

[17] *Current selling price* and *net realizable value* differ conceptually, although they may give the same amount under certain conditions: (1) future sales price is expected to be the same as current sales price (or no better estimate of future sales price than current price is available), (2) no future costs are expected, and (3) discounting is ignored.

CHAPTER 4 Objectives of Financial Accounting and Financial Statements

73. The basic purpose of financial accounting and financial statements is to provide quantitative financial information about a business enterprise that is useful to statement users, particularly owners and creditors, in making economic decisions. This purpose includes providing information that can be used in evaluating management's effectiveness in fulfilling its stewardship and other managerial responsibilities. Within the framework of these purposes financial accounting and financial statements have a number of objectives that (1) determine the appropriate content of financial accounting information (general objectives) and (2) indicate the qualities that make financial accounting information useful (qualitative objectives). The objectives provide means to evaluate and improve generally accepted accounting principles (see paragraph 213).

74. The content of financial accounting information can be examined on two levels. First, the appropriate content of particular financial statements prepared at a given date may be examined. Second, the appropriate content of financial accounting information in general, without regard for the conventions at any particular date, may be examined.

OBJECTIVES OF PARTICULAR FINANCIAL STATEMENTS

75. The objectives of particular financial statements are to present fairly in conformity with generally accepted accounting principles[18] (1) financial position, (2) results of operations, and (3) other changes in financial position. Financial position and changes in financial position of an enterprise are defined in terms of its economic resources and obligations and changes in them that are identified and measured in conformity with accounting principles that are generally accepted at the time the statements are prepared.[19]

GENERAL OBJECTIVES

76. The objectives of particular financial statements are stated in terms of the accounting principles that are generally accepted at the time the financial statements are prepared. These principles may change in response to a variety of forces.[20] General objectives that give direction to the development of accounting principles are therefore required. These general objectives are broader or longer range than those for particular financial statements and indicate the appropriate content of financial accounting information in general. They are independent of generally accepted accounting principles at any particular time. Improving financial accounting to better achieve the general objectives involves difficulties, which are discussed in paragraphs 110 to 113.

Statement of the General Objectives

77. A general objective of financial accounting and financial statements is to provide reliable financial information about economic resources and obligations of a business enterprise. This information is important in evaluating the enterprise's strengths and weaknesses. It indicates how enterprise resources are financed and the pattern of its holdings of resources. It aids in evaluating the enterprise's ability to meet its commitments. The information indicates the present resource base available to exploit opportunities and make future progress. In short, information about economic resources and obligations of a business enterprise is needed to form judgments about the ability of the enterprise to survive, to adapt, to grow, and to prosper amid changing economic conditions.

78. Another general objective, of prime importance, is to provide reliable information about changes in net resources (resources less obligations) of an enterprise that result from its profit-directed activities.[21] Almost all who are directly concerned with the economic activities of an enterprise are interested in its ability to operate successfully. Investors expect a dividend return or increases in the price of ownership shares

[18] See paragraphs 137-140 for a discussion of the nature of generally accepted accounting principles. See paragraph 189 for a discussion of fair presentation in conformity with generally accepted accounting principles.

[19] See paragraphs 130-135 in Chapter 5.

[20] See paragraphs 208-209 for a discussion of the dynamic nature of financial accounting.

[21] The term *profit-directed activities* is used in this Statement to refer to all activities of an enterprise except transfers between the enterprise and its owners.

or both. An enterprise that operates successfully is more likely to be able to pay creditors and suppliers, provide jobs for employees, pay taxes, and generate funds for expansion. Management of the enterprise also needs information about economic progress to plan operations and evaluate progress in comparison with previously established goals. To survive, the enterprise needs some minimum level of success in its profit-directed activities over the long run.

79. A related general objective is to provide financial information that assists in estimating the earning potential of the enterprise... Information about the past and present may help users of the information in making predictions. Trend figures usually (though not invariably) are better aids to prediction than the results of a single year. Extrapolations of financial data, however, should be made only in conjunction with the best additional information available about the enterprise, its circumstances, and its prospects.

80. Another general objective is to provide other needed information about changes in economic resources and obligations. Examples are information about changes in residual interest from sources other than profit-directed activities and information about working capital or fund flows.

81. A further general objective is to disclose, to the extent possible, other information related to the financial statements that is relevant to statement users' needs. Examples of disclosures of this type are information about the enterprise's accounting policies, such as depreciation and inventory methods, and information about contingent obligations of the enterprise.

82. Underlying the preceding discussion is the recognition that decisions of financial statement users involve the process of choosing among alternative courses of action. Owners make choices on whether to increase, retain, or dispose of holdings in various enterprises. Creditors often must choose between enterprises in deciding whether to extend credit. Management makes choices, for example, between alternative business activities and between alternative investments. Generally, statement users compare performance both between enterprises and over two or more reporting periods for the same enterprise. (See paragraphs 93 and 95 to 105 for a discussion of comparability in financial accounting.)

Discussion of General Objectives

83. The general objectives aid in improving accounting principles by relating the content of the information to the underlying activities of business enterprises and to the interests and needs of users of the information.

84. The general objectives do not specify which resources and obligations and changes should be measured and reported as assets, liabilities, revenue, and expenses in financial accounting. They contain no implication that assets and liabilities ideally should include *all* resources and obligations or that *all* changes in assets and liabilities ideally shoud be reported.[22] Furthermore, they do not specify how the resources and obligations to be recorded should be measured. A complementary set of objectives, the qualitative objectives, aid in determining which resources and obligations and changes should be measured and reported and how they should be measured and reported to make the information most useful.

QUALITATIVE OBJECTIVES

85. Certain qualities or characteristics make financial information useful. Providing information that has each of these qualities is an objective of financial accounting. These qualitative objectives are at least partially achieved at present, although improvement is probably possible in connection with each of them. Constraints on full achievement of the qualitative objectives are caused by conflicts of objectives, by environmental influences, and by lack of complete understanding of the objectives (see paragraphs 110 to 113).

86. The qualitative objectives are related to the broad ethical goals of truth, justice, and fairness that are accepted as desirable goals by society as a whole. To the extent that the objectives are met, progress is made toward achieving the broad ethical goals as well as toward making financial information more useful. The qualitative objectives are less abstract than the ethical

[22] Not all resources and obligations and changes in them are presently reported. For example, rights under executory contracts, obligations whose amounts are indeterminate, and changes in market price of productive resources are generally not recorded as assets, liabilities, revenue, and expenses, although they may be disclosed. (See Chapters 6-8 on generally accepted accounting principles.)

goals of truth, justice, and fairness and can therefore be applied more directly to financial accounting. Nevertheless, they are also generalizations that require judgment in using them to evaluate and improve accounting principles.

Statement of the Qualitative Objectives

87. The Board believes that financial accounting has seven qualitative objectives (0-1 to 0-7). The primary qualitative objective is relevance.

88.

0-1. *Relevance.* Relevant financial accounting information bears on the economic decisions for which it is used.

The objective of relevance helps in selecting methods of measuring and reporting in financial accounting that are most likely to aid users in making the types of economic decisions for which they use financial accounting data.[23] In judging relevance of general-purpose information attention is focused on the common needs of users and not on specific needs of particular users. A vital task is to determine these common needs and the information that is relevant to them (see paragraphs 46 and 48). Relevance is the primary qualitative objective because information that does not bear on the decisions for which it is used is useless, regardless of the extent to which it satisfies the other objectives.

89.

0-2. *Understandability.* Understandable financial accounting information presents data that can be understood by users of the information and is expressed in a form and with terminology adapted to the users' range of understanding.

Understandability is important because accounting information must be intelligible if it is to be useful. Users of financial statements can understand the information only if the data presented and their method of presentation are meaningful to them. Understandability also requires that the users have some understanding of the complex economic activities of enterprises, the financial accounting process, and the technical terminology used in financial statements.

90.

0-3. *Verifiability.* Verifiable financial accounting information provides results that would be substantially duplicated by independent measurers using the same measurement methods.

Measurements cannot be completely free from subjective opinions and judgments. The process of measuring and presenting information must use human agents and human reasoning and therefore is not founded solely on an "objective reality." Nevertheless, the usefulness of information is enhanced if it is verifiable, that is, if the attribute or attributes selected for measurement and the measurement methods used provide results that can be corroborated by independent measurers.

91.

0-4. *Neutrality.* Neutral financial accounting information is directed toward the common needs of users and is independent of presumptions about particular needs and desires of specific users of the information.

Measurements not based on presumptions about the particular needs of specific users enhance the relevance of the information to common needs of users. Preparers of financial accounting information should not try to increase the helpfulness of the information to a few users to the detriment of others who may have opposing interests.

92.

0-5. *Timeliness.* Timely financial accounting information is communicated early enough to be used for the economic decisions which it might influence and to avoid delays in making those decisions.

93.

0-6. *Comparability.* Comparable financial accounting information presents similarities and differences that arise from basic similarities and differences in the enterprise or enterprises and their transactions and not merely from differences in financial accounting treatments.

Problems in achieving comparability are discussed in paragraphs 95 to 105.

94.

0-7. *Completeness.* Complete financial accounting information includes all financial accounting data that reasonably fulfill the requirements of the other qualitative objectives (0-1 to 0-6).

The first six qualitative objectives specify qualities that are desirable in reported financial information. The objective of completeness specifies that all information that has the six qualities in reasonable degree should be reported.

[23] See discussion on uses and users in Chapter 3, paragraphs 43-48.

Comparability

95. Comparability means the ability to bring together for the purpose of noting points of likeness and difference. Comparability of financial information generally depends on like events being accounted for in the same manner. Comparable financial accounting information facilitates conclusions concerning relative financial strengths and weaknesses and relative success, both between periods for a single enterprise and between two or more enterprises.

96. *Comparability Within a Single Enterprise.* A comparison of the financial statements of one enterprise at one date or for one period of time with those of the same enterprise at other dates or for other periods of the same length is more informative if the following conditions exist:

(1) The presentations are in the same form—that is, the arrangement within the statements is identical.

(2) The content of the statements is identical—that is, the same items from the underlying accounting records are classified under the same captions.

(3) Accounting principles are not changed or, if they are changed, the financial effects of the changes are disclosed.

(4) Changes in circumstances or in the nature of the underlying transactions are disclosed.

97. If these four conditions are satisfied, a comparison of the financial statements furnishes useful information about differences in the results of operations for the periods involved or in the financial positions at the dates specified. To the extent, however, that any one of the conditions is not met, comparisons may be misleading.

98. *Consistency*—Consistency is an important factor in comparability within a single enterprise. Although financial accounting practices and procedures are largely conventional, consistency in their use permits comparisons over time. If a change of practice or procedure is made, disclosure of the change and its effect permits some comparability, although users can rarely make adjustments that make the data completely comparable.

99. *Regular reporting periods*—Regular reporting periods are also an important factor in comparability within a single enterprise. Periods of equal length facilitate comparisons between periods. Comparing the results of periods shorter than a year, even though the periods are of equal length, however, may require consideration of seasonal factors.

100. *Comparability Between Enterprises.* Comparability between enterprises is more difficult to attain than comparability within a single enterprise. Widespread public interest in investment opportunities in recent years has focused attention on the desirability of achieving greater comparability of financial statements.

101. To make comparisons between enterprises as meaningful as possible, the four conditions outlined in paragraph 96 as well as other conditions should be satisfied. The most important of the other conditions is that, ideally, differences between enterprises' financial statements should arise from basic differences in the enterprises themselves or from the nature of their transactions and not merely from differences in financial accounting practices and procedures. One of the most important unsolved problems at present, therefore, is the general acceptance of alternative accounting practices under circumstances which themselves do not appear to be sufficiently different to justify different practices.

102. Achieving comparability between enterprises depends on accomplishing two difficult tasks: (1) identifying and describing the circumstances that justify or require the use of a particular accounting practice or method, (2) eliminating the use of alternative practices under these circumstances. If these tasks can be accomplished, basic differences under which enterprises operate can be reflected by appropriate, and possibly different, practices.

103. Pending accomplishment of these tasks, users of financial statements should recognize that financial statements of different enterprises may not be fully comparable; that is, they may to an unknown extent reflect differences unrelated to basic differences in the enterprises and in their transactions. Evaluation of differences is not completely effective in the absence of criteria governing the applicability of various practices and methods.

104. Supplemental disclosures are sometimes directed toward overcoming this present weakness in financial reporting, but disclosure does not necessarily make financial statements comparable. For example, a statement user may not safely assume that he has made comparable the financial statements of two enterprises which use different accounting methods even though he has been able to put them on the same

inventory or depreciation method through the use of disclosed information, because the circumstances may differ to such an extent that similar methods may not be appropriate.

105. The Accounting Principles Board and others in the accounting profession are continuing to work on problems of comparability between enterprises. The Board has, for example, developed criteria for application of practices and procedures in some problem areas and expects to deal with others in the future. The great variety of business enterprises and the large number of different circumstances in which enterprises operate, even within the same industry, make the task a difficult one. The Board ranks comparability among the most important of the objectives of financial accounting, however, and is attempting to narrow areas of difference in accounting practices that are not justified by differences in circumstances.

Adequate Disclosure

106. Financial information that meets the qualitative objectives of financial accounting also meets the reporting standard of adequate disclosure.[24] Adequate disclosure relates particularly to objectives of relevance, neutrality, completeness, and understandability. Information should be presented in a way that facilitates understanding and avoids erroneous implications. The headings, captions, and amounts must be supplemented by enough additional data so that their meaning is clear but not by so much information that important matters are buried in a mass of trivia.

Reliability of Financial Statements

107. Achievement of the qualitative objectives of financial accounting enhances the reliability of financial statements. Reliability of information is important to users because decisions based on the information may affect their economic well-being. Reliability does not imply precision of the information in financial statements because financial accounting involves approximation and judgment (see paragraphs 123 and 124).

108. The responsibility for the reliability of an enterprise's financial statement rests with its management. This responsibility is discharged by applying generally accepted accounting principles that are appropriate to the enterprise's circumstances, by maintaining effective systems of accounts and internal control, and by preparing adequate financial statements.

109. The users of financial statements also look to the reports of independent auditors to ascertain that the financial statements have been examined by independent experts who have expressed their opinion as to whether or not the information is presented fairly in conformity with generally accepted accounting principles consistently applied.

ACHIEVING THE OBJECTIVES

110. The objectives of financial accounting and financial statements are at least partially achieved at present, although improvement is probably possible in connection with each of them. The objectives are often difficult to achieve, however, and are usually not equally capable of attainment. Constraints on full achievement of the objectives arise from (1) conflicts of objectives, (2) environmental influences, and (3) lack of complete understanding of the objectives.

111. The pursuit of one objective or one set of objectives may conflict with the pursuit of others. It is not always possible, for example, to have financial statements that are highly relevant on the one hand and also timely on the other. Nor is it always possible to have financial accounting information that is both as verifiable and as relevant as desired. Only if all other objectives are not affected will a change in information that increases compliance with one objective be certain to be beneficial. Conflicts between qualitative objectives might be resolved by arranging the objectives in order of relative importance and determining desirable trade-offs, but, except for the primacy of relevance, neither accountants nor users now agree as to their relative importance. Determining the trade-offs that are desirable requires judgment.

112. Constraints on achieving the objectives may stem from influences of the environment on accounting. First, the objectives, which are based largely on the needs of users of financial information, are

[24] Statements on Auditing Procedure No. 33, *Auditing Standards and Procedures*, p. 16.

not necessarily compatible with environmental influences. The inherent difficulties of measurement in terms of money, for example, mean that information produced by accounting will necessarily fall short to some extent of objectives of verifiability and comparability. Second, financial accounting costs money. Anticipated benefits from proposed changes in financial accounting information that are intended to better achieve the objectives must be weighed against the additional cost involved. Finally, changing financial accounting practices to better achieve the objectives involves user costs and dislocations that may tend to offset the advantages to be obtained. For example, changing practices may affect business arrangements that were initiated on the basis of practices before the change. Also, the costs of learning how to use new types of information and the reluctance to change ways of using information may reduce the benefits otherwise obtainable from improvements.

113. The Board believes that the objectives discussed in this chapter are helpful in evaluating and improving financial accounting information even though they are stated in general terms. Obtaining clearer understanding of the nature and implications of the objectives is an important prerequisite to further improvement of financial accounting and financial statements.

CHAPTER 5 Basic Features and Basic Elements of Financial Accounting

BASIC FEATURES OF FINANCIAL ACCOUNTING

114. The basic features of financial accounting are a distillation of the effects of environmental characteristics (described in Chapter 3) on the financial accounting process. These features underlie present generally accepted accounting principles, discussed in Chapters 6 to 8, but they could also serve as a foundation for other accounting principles that are based on the same environmental characteristics.

Statement of the Basic Features of Financial Accounting

115. The following thirteen statements (F-1 to F-13) describe the basic features of financial accounting. Each statement contains a parenthetical reference to environmental characteristics from which it is, at least in part, derived.

116.

> F-1. *Accounting entity.* Accounting information pertains to entities, which are circumscribed areas of interest. In financial accounting the entity is the specific business enterprise. The enterprise is identified in its financial statements. (Paragraphs 51, 56)

Attention in financial accounting is focused on the economic activities of individual business enterprises. The boundaries of the accounting entity may not be the same as those of the legal entity, for example, a parent corporation and its subsidiaries treated as a single business enterprise.

117.

> F-2. *Going concern.* An accounting entity is viewed as continuing in operation in the absence of evidence to the contrary.[28] (Paragraph 55)

Because of the relative permanence of enterprises, financial accounting is formulated basically for going concerns. Past experience indicates that continuation of operations is highly probable for most enterprises although continuation cannot be known with certainty. An enterprise is not viewed as a going concern if liquidation appears imminent.

118.

> F-3. *Measurement of economic resources and obligations.* Financial accounting is primarily concerned with measurement of economic resources and obligations and changes in them. (Paragraphs 49, 56-58, 61-63, 66)

The subject matter of financial accounting is economic activity and financial accounting therefore involves measuring and reporting on the creation, accumulation, and use of economic resources. Economic activities that can be quantified are emphasized in financial accounting. Accounting does not deal directly with subjective concepts of welfare or satisfactions; its focus is not sociological or psychological.

[28] The corollary observation is that if liquidation appears imminent, financial information may be prepared on the assumption that liquidation will occur.

119.

F-4. *Time periods.* The financial accounting process provides information about the economic activities of an enterprise for specified time periods that are shorter than the life of the enterprise. Normally the time periods are of equal length to facilitate comparisons. The time period is identified in the financial statements. (Paragraphs 52, 54-55, 67)

Interested parties make evaluations and decisions at many points in the lives of enterprises. The continuous activities of enterprises are therefore segmented into relatively short periods of time so that information can be prepared that will be useful in decisions.

120.

F-5. *Measurement in terms of money.* Financial accounting measures monetary attributes of economic resources and obligations and changes in them. The unit of measure is identified in the financial statements. (Paragraphs 51, 56, 66, 69-70)

Measurement in terms of money focuses attention on monetary attributes of resources and obligations; other aspects, such as physical attributes, are not emphasized. Money measurement entails significant problems (see paragraphs 67, 68, and 72).

121.

F-6. *Accrual.* Determination of periodic income and financial position depends on measurement of economic resources and obligations and changes in them as the changes occur rather than simply on recording receipts and payments of money. (Paragraphs 56, 59-61, 63, 66, 68, 70)

Enterprise economic activity in a short period seldom follows the simple form of a cycle from money to productive resources to product to money. Instead, continuous production, extensive use of credit and long-lived resources, and overlapping cycles of activity complicate the evaluation of periodic activities. As a result, noncash resources and obligations change in time periods other than those in which money is received or paid. Recording these changes is necessary to determine periodic income and to measure financial position. This is the essence of accrual accounting.

122.

F-7. *Exchange price.* Financial accounting measurements are primarily based on prices at which economic resources and obligations are exchanged. (Paragraphs 51, 67, 69-72)

Measurement in terms of money is based primarily on exchange prices. Changes in resources from other than exchanges (for example, production) are measured by allocating prices in prior exchanges or by reference to current prices for similar resources. The multiple concepts of exchange price (paragraph 70) require decisions about the prices relevant to the uses of financial accounting information.

123.

F-8. *Approximation.* Financial accounting measurements that involve allocations among relatively short periods of time and among complex and joint activities are necessarily made on the basis of estimates. (Paragraphs 51-52, 54-55, 67, 72)

The continuity, complexity, uncertainty, and joint nature of results inherent in economic activity often preclude definitive measurements and make estimates necessary.

124.

F-9. *Judgment.* Financial accounting necessarily involves informed judgment. (Paragraphs 43, 46-47, 54-55, 67-68, 71-72)

The estimates necessarily used in financial accounting (F-8) involve a substantial area of informed judgment. This precludes reducing all of the financial accounting process to a set of inflexible rules.

125.

F-10. *General-purpose financial information.* Financial accounting presents general-purpose financial information that is designed to serve the common needs of owners, creditors, managers, and other users, with primary emphasis on the needs of present and potential owners and creditors. (Paragraphs 44-47, 63)

General-purpose financial statements are prepared by an enterprise under the presumption that users have common needs for information (see paragraph 46). Although special-purpose information may be prepared from financial accounting records, it is not the primary product of financial accounting and is not discussed in this Statement.

126.

F-11. *Fundamentally related financial statements.* The results of the accounting process are expressed in statements of financial position and changes in financial position, which are based on the same underlying data and are fundamentally related. (Paragraphs 61, 63, 68)

The basic interrelationships between economic resources and economic obligations and changes in them make measurement of periodic net income and of assets and liabilities part of the same process and require that the financial statements be fundamentally related. The measurement bases used to quantify changes in financial position are necessarily related to the measurement bases of the resources and obligations used in representations of financial position.

127.

F-12. *Substance over form.* Financial accounting emphasizes the economic substance of events even though the legal form may differ from the economic substance and suggest different treatment. (Paragraphs 41, 64, 66)

Usually the economic substance of events to be accounted for agrees with the legal form. Sometimes, however, substance and form differ. Accountants emphasize the substance of events rather than their form so that the information provided better reflects the economic activities represented.

128.

F-13. *Materiality.* Financial reporting is only concerned with information that is significant enough to affect evaluations or decisions. (Paragraphs 43-45)

Basic Features and the Environment

129. The basic features of financial accounting described above are the result of environmental factors and influence the financial accounting process. The relationships between the features and the environment and among the features themselves are complex. The relationships between environmental conditions and the basic features of financial accounting can be illustrated with examples. The importance of money in a highly developed economy is the basis for the feature of measurement in terms of money (F-5). The complexity and continuity of economic activity, the joint nature of economic results, and the uncertain outcome of economic activity are important factors in the features of approximation (F-8) and judgment (F-9).

BASIC ELEMENTS OF FINANCIAL ACCOUNTING

130. The basic elements of financial accounting—assets, liabilities, owners' equity, revenue, expenses, and net income (net loss)—are related to the economic resources, economic obligations, residual interest, and changes in them which are discussed in Chapter 3. Not all economic resources and obligations and changes in them are recognized and measured in financial accounting. The objectives of financial accounting (Chapter 4) provide broad criteria that aid in selecting economic resources, obligations, and changes in them for recognition and measurement. The basic features are additional factors in determining which economic elements and changes in them are recognized and measured. The particular economic elements and changes to be recognized and measured at any time as the basic elements of financial accounting are determined by generally accepted accounting principles in effect at that time. The basic elements of financial accounting therefore are defined in terms of both (1) economic resources and obligations of enterprises, and (2) generally accepted accounting principles.

131. Because generally accepted accounting principles change, the concepts of assets, liabilities, owners' equity, revenue, expenses, and net income also change, subject to the constraints of the economic elements referred to in their definitions. The definitions themselves, therefore, provide criteria for determining those economic resources, economic obligations, and changes in them that *are* included in the basic elements at any particular time but do not provide criteria for determining from a broader or longer-range perspective those economic elements that *should be* included in the basic elements. Under the definitions given, determining the items that should be included in the basic elements is part of the overall problem of determining what generally accepted accounting principles should be. Criteria intended to help solve that problem are provided by the general and qualitative objectives of financial accounting and financial statements (Chapter 4).

Financial Position

132. The basic elements of the financial position of an enterprise are assets, liabilities, and owners' equity.

Assets—economic resources of an enterprise that are recognized and measured in conformity with generally accepted accounting principles. Assets also include certain deferred charges that are not resources[26] but that are recognized and measured in conformity with generally accepted accounting principles.[27]

Liabilities—economic obligations of an enterprise that are recognized and measured in conformity with generally accepted accounting principles. Liabilities also include certain deferred credits that are not obligations[28] but that are recognized and measured in conformity with generally accepted accounting principles.[29]

Owners' equity—the interest of owners in an enterprise, which is the excess of an enterprise's assets over its liabilities.[30]

Owners' equity is defined in terms of assets and liabilities, just as residual interest is defined in terms of economic resources and obligations (see paragraph 59). The relationship among assets, liabilities, and owners' equity implicit in the definition of owners' equity is:

Assets — Liabilities = Owners' Equity[31]

133. The *financial position* of an enterprise at a particular time comprises its assets, liabilities, and owners' equity and the relationship among them, plus those contingencies, commitments, and other financial matters that pertain to the enterprise at that time and are required to be disclosed under generally accepted accounting principles. The financial position of an enterprise is presented in the *balance sheet*[32] and in notes to the financial statements.

Results of Operations

134. The basic elements of the results of operations of an enterprise are revenue, expenses, and net income:

Revenue—gross increases in assets or gross decreases in liabilities recognized and measured in conformity with generally accepted accounting principles that result from those types of profit-directed activities[33] of an enterprise that can change owners' equity.[34]

Increases in assets and decreases in liabilities designated as revenue are related to changes in resources and obligations discussed in paragraph 61. Revenue does not, however, include all recognized increases in assets or decreases in liabilities. Revenue results only from those types of profit-directed activities that can change owners' equity under generally accepted accounting principles. Receipt of the proceeds of a cash sale is revenue under present generally accepted accounting principles, for example, because the net result of the sale is a change in owners' equity.[35] On the other hand, receipt of the proceeds of a loan or receipt of an asset purchased for cash, for example, is not revenue under present generally accepted accounting principles because owners' equity can not change at the time of the loan or purchase.

Expenses—gross decreases in assets or gross increases in liabilities recognized and measured in conformity with generally accepted accounting principles that

[26] Deferred charges from income tax allocation are an example of deferred charges that are not resources. The term *deferred charges* is also sometimes used to refer to certain resources, for example, prepaid insurance.

[27] This definition differs from that in Accounting Terminology Bulletin No. 1, paragraph 26, which defines assets as debit balances carried forward upon a closing of books of account that represent property values or rights acquired.

[28] Deferred credits from income tax allocation are an example of deferred credits that are not obligations. The term *deferred credits* is also sometimes used to refer to certain obligations, for example, subscriptions collected in advance.

[29] This definition differs from that in Accounting Terminology Bulletin No. 1, paragraph 27, in that (1) it defines liabilities primarily in terms of obligations rather than as credit balances carried forward upon closing the books, and (2) it excludes capital stock and other elements of owners' equity.

[30] This definition isolates owners' equity as a separate element. Owners' equity is included in the definition of liabilities in Accounting Terminology Bulletin No. 1, paragraph 27. Owners' equity is conventionally classified into several categories, see paragraph 198.

[31] Expressing the relationship in a mathematical equation goes beyond descriptions of terms and assumes appropriate measurement. Measurement of economic activity is discussed in paragraphs 66-72.

[32] The definition of balance sheet in this paragraph differs from that in Accounting Terminology Bulletin No. 1, paragraph 21, in that it defines the content in terms of assets, liabilities, and owners' equity, rather than balances carried forward after closing books kept according to principles of accounting.

[33] See paragraph 78, footnote 21, for the definition of profit-directed activities.

[34] The definition of revenue in this paragraph differs from that in Accounting Terminology Bulletin No. 2, paragraphs 5-7, in that (1) it emphasizes the nature of revenue rather than the usual point of recognition—the sale, (2) it includes the proceeds rather than only the gain from sale or exchange of assets "other than stock in trade." Gain is defined in this Statement as a net concept, the result of deducting expenses from revenue. See paragraph 198 for a discussion of gains in financial accounting.

[35] If by coincidence the proceeds of a sale are equal to the cost and owners' equity does not change, receipt of the proceeds is nevertheless revenue because a sale is a type of event in which owners' equity can change under present generally accepted accounting principles.

result from those types of profit-directed activities of an enterprise that can change owners' equity.[26]

Decreases in assets and increases in liabilities designated as expenses are related to changes in resources and obligations discussed in paragraph 61. Expenses, like revenue, result only from those types of profit-directed activities that can change owners' equity under generally accepted accounting principles. Delivery of product in a sale is an expense under present generally accepted accounting principles, for example, because the net result of the sale is a change in owners' equity. On the other hand, incurring a liability for the purchase of an asset is not an expense under present generally accepted accounting principles because owners' equity can not change at the time of the purchase.

Net income (net loss)—the excess (deficit) of revenue over expenses for an accounting period, which is the net increase (net decrease) in owners' equity (assets minus liabilities) of an enterprise for an accounting period from profit-directed activities that is recognized and measured in conformity with generally accepted accounting principles.

The relationship among revenue, expenses, and net income (net loss) implicit in the definition of net income (net loss) is:

Revenue − Expenses = Net Income (Net Loss)[27]

135. The *results of operations* of an enterprise for a period of time comprises the revenue, expenses, and net income (net loss) of the enterprise for the period. The results of operations of an enterprise is presented in the *income statement.*

Interrelationship of Financial Position and Results of Operations

136. The financial position and results of operations of an enterprise are fundamentally related. Net income (net loss) for an accounting period, adjustments of income of prior periods, and investments and withdrawals by owners during the period constitute the change during the period in owners' equity, an element of financial position. Other relationships between the income statement and the balance sheet, for example, the relationship of cost of goods sold to inventory and of depreciation to fixed assets, are further indications of the interrelatedness of the statements.

CHAPTER 6 Generally Accepted Accounting Principles—Pervasive Principles

GENERALLY ACCEPTED ACCOUNTING PRINCIPLES

137. Financial statements are the product of a process in which a large volume of data about aspects of the economic activities of an enterprise are accumulated, analyzed, and reported. This process should be carried out in accordance with generally accepted accounting principles. Generally accepted accounting principles incorporate the consensus[28] at a particular time as to which economic resources and obligations should be recorded as assets and liabilities by financial accounting, which changes in assets and liabilities should be recorded, when these changes should be recorded, how the assets and liabilities and changes in them should be measured, what informa-

[26] This definition of expenses differs from that given in Accounting Terminology Bulletin No. 4, paragraphs 3-4, and 6. It is similar to the "broad" definition in the Terminology Bulletin except that it includes the cost of assets "other than stock in trade" disposed of rather than only the loss (see paragraph 198 for a discussion of losses in financial accounting). The "narrow" definition of expenses recommended in the Terminology Bulletin for use in financial statements excludes "cost of goods or services sold" from expenses and is incompatible with the definition in this Statement. Expense in this "narrow" sense should always be modified by appropriate qualifying adjectives, for example, *selling and administrative expense* or *interest expense.*

[27] Expressing the relationship in a mathematical equation goes beyond descriptions of terms and assumes appropriate measurement. Measurement of economic activity is discussed in paragraphs, 66-72.

[28] Inasmuch as generally accepted accounting principles embody a consensus, they depend on notions such as *general acceptance* and *substantial authoritative support,* which are not precisely defined. The Securities and Exchange Commission indicated in Accounting Series Release No. 4 that when financial statements are "prepared in accordance with accounting principles for which there is no substantial authoritative support, such financial statements will be presumed to be misleading or inaccurate. . . ." The AICPA Special Committee on Opinions of the Accounting Principles Board defines *generally accepted accounting principles* as those "having substantial authoritative support." Problems in defining substantial authoritative support are discussed in Marshall Armstrong, "Some Thoughts on Substantial Authoritative Support," *The Journal of Accountancy,* April 1969, pp. 44-50.

tion should be disclosed and how it should be disclosed and which financial statements should be prepared.

138. *Generally accepted accounting principles* therefore is a technical term in financial accounting. Generally accepted accounting principles encompass the conventions, rules, and procedures necessary to define accepted accounting practice at a particular time. The standard[39] of "generally accepted accounting principles" includes not only broad guidelines of general application, but also detailed practices and procedures.[40]

139. Generally accepted accounting principles are conventional—that is, they become generally accepted by agreement (often tacit agreement) rather than by formal derivation from a set of postulates or basic concepts. The principles have developed on the basis of experience, reason, custom, usage, and, to a significant extent, practical necessity.

140. In recent years Opinions of the Accounting Principles Board have received considerable emphasis as a major determinant of the composition of generally accepted accounting principles. All of the Accounting Research Bulletins and the early Opinions of the Accounting Principles Board include the statement that ". . . the authority of the bulletins [or Opinions] rests upon their general acceptability. . . ." Beginning with Opinion No. 6 (October 1965), however, Opinions of the Accounting Principles Board include a statement to reflect the adoption in October 1964 by Council of the American Institute of Certified Public Accountants of a resolution that provides in essence that accounting principles accepted in Opinions of the Accounting Principles Board constitute, per se, generally accepted accounting principles for Institute members. The Council also recognizes that accounting principles that differ from those accepted in Opinions of the Accounting Principles Board can have substantial authoritative support and, therefore, can also be considered to be generally accepted accounting principles.

141. In this Statement the discussion of present generally accepted accounting principles is divided into three sections: (1) pervasive principles, which relate to financial accounting as a whole and provide a basis for the other principles, (2) broad operating principles, which guide the recording, measuring, and communicating processes of financial accounting, and (3) detailed principles, which indicate the practical application of the pervasive and broad operating principles. This classification provides a useful framework for analysis, although the distinctions between the types of principles, especially between the broad operating and detailed principles, are somewhat arbitrary. This chapter discusses the pervasive principles. The broad operating and detailed principles are discussed in Chapters 7 and 8, respectively.

142. The three types of principles form a hierarchy. The pervasive principles are few in number and fundamental in nature. The broad operating principles derived from the pervasive principles are more numerous and more specific, and guide the application of a series of detailed principles. The detailed principles are numerous and specific. Detailed principles are generally based on one or more broad operating principles and the broad operating principles are generally based on the pervasive principles. No attempt is made in this Statement to indicate specific relationships between principles.

PERVASIVE PRINCIPLES

143. The pervasive principles specify the general approach accountants take to recognition and measurement of events that affect the financial position and results of operations of enterprises. The pervasive principles are divided into (1) pervasive measurement principles and (2) modifying conventions.

Pervasive Measurement Principles

144. The pervasive measurement principles (P-1 to P-6) establish the basis for implementing accrual accounting. They include the initial recording principle, the realization principle, three pervasive expense recognition principles, and the unit of measure principle. These principles broadly determine (1) the types of events to be recognized by financial accounting, (2) the bases on which to measure the events, (3) the time periods with which to identify the events, and (4) the common denominator of measurement.

[39] The independent auditor's report gives the auditor's opinion as to whether the financial statements "present fairly the financial position . . . and the results of . . . operations, in conformity with generally accepted accounting principles. . . ."

[40] "The term 'principles of accounting' as used in reporting standards is construed to include not only accounting principles and practices but also the methods of applying them." Statements on Auditing Procedure No. 33, *Auditing Standards and Procedures*, p. 40.

145. *Initial Recording.* The principle for initial recording of assets and liabilities is important in financial accounting because it determines (1) the data that enter the accounting process, (2) the time of entry, and (3) generally the amounts at which assets, liabilities, revenue, and expenses are recorded.

P-1. *Initial recording of assets and liabilities.* Assets and liabilities generally are initially recorded on the basis of events in which the enterprise acquires resources from other entities or incurs obligations to other entities.[41] The assets and liabilities are measured by the exchange prices[42] at which the transfers take place.

146. The initial recording of assets and liabilities may also reflect the elimination of other assets or liabilities, for example, the payment of cash in acquiring equipment. The amounts at which assets and liabilities are initially recorded may be carried without change, may be changed, for example, by amortization or write off, or may be shifted to other categories. The effects of transactions or other events to which the entity is not a party are usually not recognized in the accounting records until transactions of the enterprise occur, although there are significant exceptions to this general principle (see paragraph 183). The effects of executory contracts also are generally not recognized until one of the parties at least partially fulfills his commitment.

147. *Income Determination.*[43] Income determination in accounting is the process of identifying, measuring, and relating revenue and expenses of an enterprise for an accounting period. Revenue for a period is generally determined independently by applying the realization principle. Expenses are determined by applying the expense recognition principles on the basis of relationships between acquisition costs[44] and either the independently determined revenue or accounting periods. Since the point in time at which revenue and expenses are recognized is also the time at which changes in amounts of net assets are recognized, income determination is interrelated with asset valuation. From the perspective of income determination, costs are divided into (1) those that have "expired" and become expenses and (2) those that are related to later periods and are carried forward as assets in the balance sheet. From the perspective of asset valuation, those costs that no longer meet the criteria of assets become expenses and are deducted from revenue in determining net income.

148. *Revenue and Realization.* Revenue is a gross increase in assets or a gross decrease in liabilities recognized and measured in conformity with generally accepted accounting principles that results from those types of profit-directed activities of an enterprise that can change owners' equity (see paragraph 134). Revenue under present generally accepted accounting principles is derived from three general activities: (a) selling products, (b) rendering services and permitting others to use enterprise resources, which result in interest, rent, royalties, fees, and the like, and (c) disposing of resources other than products—for example, plant and equipment or investments in other entities. Revenue does not include receipt of assets purchased, proceeds of borrowing, investments by owners, or adjustments of revenue of prior periods.

149. Most types of revenue are the joint result of many profit-directed activities of an enterprise and revenue is often described as being "earned" gradually and continuously by the whole of enterprise activities. *Earning* in this sense is a technical term that refers to the activities that give rise to the revenue — purchasing, manufacturing, selling, rendering service, delivering goods, allowing other entities to use enterprise assets, the occurrence of an event specified in a contract, and so forth. All of the profit-directed activities of an enterprise that comprise the process by which revenue is earned may be called the *earning process.*

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[41] This principle does not cover the first recording of assets produced or constructed by the enterprise from other assets that previously have been initially recorded. Accounting for produced or self-constructed assets is discussed in paragraph 159.

[42] In transfers that do not involve money prices, such as barter transactions or investments by owners, assets are usually measured at "fair value," that is, at the amount of money that would be involved, if the assets were received in exchanges that involved money prices. For exceptions to this general rule see paragraph 182, M-2B and M-2C.

[43] The term *matching* is often used in the accounting literature to describe the entire process of income determination. The term is also often applied in accounting, however, in a more limited sense to the process of expense recognition or in an even more limited sense to the recognition of expenses by associating costs with revenue on a cause and effect basis (see paragraph 157). Because of the variety of its meanings, the term *matching* is not used in this Statement.

[44] See paragraph 65 for a general discussion of the term *cost* and paragraph 164 for a discussion of the meaning of the term *cost* under present generally accepted accounting principles.

150. Revenue is conventionally recognized at a specific point in the earning process of a business enterprise, usually when assets are sold or services are rendered. This conventional recognition is the basis of the pervasive measurement principle known as realization.

> P-2. *Realization.* Revenue is generally recognized when both of the following conditions are met: (1) the earning process is complete or virtually complete, and (2) an exchange has taken place.

151. The exchange required by the realization principle determines both the time at which to recognize revenue and the amount at which to record it. Revenue from sales of products is recognized under this principle at the date of sale, usually interpreted to mean the date of delivery to customers. Revenue from services rendered is recognized under this principle when services have been performed and are billable. Revenue from permitting others to use enterprise resources, such as interest, rent, and royalties is also governed by the realization principle. Revenue of this type is recognized as time passes or as the resources are used. Revenue from sales of assets other than products is recognized at the date of sale. Revenue recognized under the realization principle is recorded at the amount received or expected to be received.

152. Revenue is sometimes recognized on bases other than the realization rule. For example, on long-term construction contracts revenue may be recognized as construction progresses. This exception to the realization principle is based on the availability of evidence of the ultimate proceeds and the consensus that a better measure of periodic income results. Sometimes revenue is recognized at the completion of production and before a sale is made. Examples include certain precious metals and farm products with assured sales prices.[45] The assured price, the difficulty in some situations of determining costs of products on hand, and the characteristic of unit interchangeability are reasons given to support this exception.

153. The realization principle requires that revenue be earned before it is recorded. This requirement usually causes no problems because the earning process is usually complete or nearly complete by the time of the required exchange. The requirement that revenue be earned becomes important, however, if money is received or amounts are billed in advance of the delivery of goods or rendering of services. For example, amounts for rent or magazine subscriptions received in advance are not treated as revenue of the period in which they are received but as revenue of the future period or periods in which they are "earned." These amounts are carried as "unearned revenue" —that is, liabilities to transfer goods or render services in the future—until the earning process is complete. The recognition of this revenue in the future period results in recording a decrease in a liability rather than an increase in an asset.

154. *Expense Recognition.* Expenses are gross decreases in assets or gross increases in liabilities recognized and measured in conformity with generally accepted accounting principles that result from those types of profit-directed activities of an enterprise that can change owners' equity (see paragraph 134). Important classes of expenses are (1) costs of assets used to produce revenue (for example, cost of goods sold, selling and administrative expenses, and interest expense), (2) expenses from nonreciprocal transfers and casualties (for example, taxes, fires, and theft), (3) costs of assets other than products (for example, plant and equipment or investments in other companies) disposed of, (4) costs incurred in unsuccessful efforts, and (5) declines in market prices of inventories held for sale. Expenses do not include repayments of borrowing, expenditures to acquire assets, distributions to owners (including acquisition of treasury stock), or adjustments of expenses of prior periods.

155. Expenses are the costs that are associated with the revenue of the period, often directly but frequently indirectly through association with the period to which the revenue has been assigned. Costs to be associated with future revenue or otherwise to be associated with future accounting periods are deferred to future periods as assets. Costs associated with past revenue or otherwise associated with prior periods are adjustments of the expenses of those prior periods.[46] The expenses of a period are (a) costs directly associated with the revenue of the period, (b) costs associated with the period on some basis other than a direct relationship with revenue, and (c) costs that cannot, as a practical matter, be associated with any other period.

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[45] This increase in assets is often reported in the income statement as a reduction of cost of goods sold rather than as sales revenue.

[46] See paragraph 174.

156. Three pervasive expense recognition principles specify the bases for recognizing the expenses that are deducted from revenue to determine the net income or loss of a period. They are "associating cause and effect," "systematic and rational allocation," and "immediate recognition."

157.

P-3. *Associating cause and effect.*[49] Some costs are recognized as expenses on the basis of a presumed direct association with specific revenue.

Although direct cause and effect relationships can seldom be conclusively demonstrated, many costs appear to be related to particular revenue and recognizing them as expenses accompanies recognition of the revenue. Examples of expenses that are recognized by associating cause and effect are sales commissions and costs of products sold or services provided.

158. Several assumptions regarding relationships must be made to accumulate the costs of products sold or services provided. For example, manufacturing costs are considered to "attach" to products on bases of association such as labor hours, area or volume of facilities used, machine hours, or other bases presumed to indicate the relationship involved. "Attaching" costs to products often requires several allocations and reallocations of costs. Also, assumptions regarding the "flow" of costs or of physical goods (LIFO, FIFO, average) are often made to determine which costs relate to products sold and which remain in inventory as assets.

159.

P-4. *Systematic and rational allocation.* In the absence of a direct means of associating cause and effect, some costs are associated with specific accounting periods as expenses on the basis of an attempt to allocate costs in a systematic and rational manner among the periods in which benefits are provided. If an asset provides benefits for several periods its cost is allocated to the periods in a systematic and rational manner in the absence of a more direct basis for associating cause and effect. The cost of an asset that provides benefits for only one period is recognized as an expense of that period (also a systematic and rational allocation). This form of expense recognition always involves assumptions about the pattern of benefits and the relationship between costs and benefits because neither of these two factors can be conclusively demonstrated. The allocation method used should appear reasonable to an unbiased observer and should be followed systematically. Examples of items that are recognized in a systematic and rational manner are depreciation of fixed assets, amortization of intangible assets, and allocation of rent and insurance. Systematic and rational allocation of costs may increase assets as product costs or as other asset costs rather than increase expenses immediately, for example, depreciation charged to inventory and costs of self-constructed assets. These costs are later recognized as expenses under the expense recognition principles.

160.

P-5. *Immediate recognition.* Some costs are associated with the current accounting period as expenses because (1) costs incurred during the period provide no discernible future benefits, (2) costs recorded as assets in prior periods no longer provide discernible benefits or (3) allocating costs either on the basis of association with revenue or among several accounting periods is considered to serve no useful purpose.

Application of this principle of expense recognition results in charging many costs to expense in the period in which they are paid or liabilities to pay them accrue. Examples include officers' salaries, most selling costs, amounts paid to settle lawsuits, and costs of resources used in unsuccessful efforts. The principle of immediate recognition also requires that items carried as assets in prior periods that are discovered to have no discernible future benefit be charged to expense, for example, a patent that is determined to be worthless.

161. *Application of Expense Recognition Principles.* To apply expense recognition principles, costs are analyzed to see whether they can be associated with revenue on the basis of cause and effect. If not, systematic and rational allocation is attempted. If neither cause and effect associations nor systematic and rational allocations can be made, costs are recognized as expenses in the period incurred or in which a loss is discerned. Practical measurement difficulties and consistency of treatment over time are important factors in determining the appropriate expense recognition principle.

162. *Effect of the Initial Recording, Realization, and Expense Recognition Principles.*

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[49] The term *matching* is often applied to this process (see paragraph 147, footnote 43).

The essential effect of these principles as they now exist is that measurement of the assets, liabilities, revenue, and expenses of a business enterprise is based primarily on its own exchanges. Resources and obligations that result from executory contracts are generally not recorded as assets and liabilities until one of the parties at least partially fulfills his commitment. Furthermore, not all changes in the utility or price of assets are recognized. Increases in assets and the related revenue are usually not recorded if they result from events wholly internal to the enterprise. For example, revenue that is earned during the production process is generally not recorded until the goods and services produced are exchanged. Also, increases or decreases in assets and related revenue and expenses that result from events in which the enterprise does not participate directly are usually not recorded.[48] For example, most changes in prices of productive resources are not recognized until enterprise transactions take place.

163. Under the initial recording, realization, and expense recognition principles assets are generally carried in the accounting records and presented in financial statements at acquisition cost or some unexpired or unamortized portion of it. When assets are sold, the difference between the proceeds realized and the unamortized portion of acquisition cost is recognized as an increase (or decrease) in the enterprise's net assets.

164. The initial recording and realization conventions are the basis for the "cost principle" (which is more accurately described as the acquisition-price or historical-cost rule). Cost can be defined in several ways —for example, as the amount of money that would be required to acquire assets currently (replacement cost) or as the return from alternative uses of assets, such as selling them (opportunity cost). However, "cost" at which assets are carried and expenses are measured in financial accounting today usually means historical or acquisition cost because of the conventions of initially recording assets at acquisition cost and of ignoring increases in assets until they are exchanged (the realization convention).[49] The term *cost* is also commonly used in financial accounting to refer to the amount at which assets are initially recorded, regardless of how the amount is determined.

165. *Unit of Measure.* In the United States, the U. S. dollar fulfills the functions of medium of exchange, unit of account, and store of value. It provides the unit of measure for financial accounting. Stating assets and liabilities and changes in them in terms of a common financial denominator is prerequisite to performing the operations —for example, addition and subtraction— necessary to measure financial position and periodic net income.

166. Defining the unit of measure in terms of money presents problems because of decreases (inflation) or increases (deflation) in the general purchasing power of money over time. The effects of inflation in the United States are not considered sufficiently important at this time to require recognition in financial accounting measurements.

> P-6. *Unit of measure.* The U. S. dollar is the unit of measure in financial accounting in the United States. Changes in its general purchasing power are not recognized in the basic financial statements.

167. *Effect of the Unit of Measure Principle.* The basic effect of this principle is that financial accounting measures are in terms of numbers of dollars, without regard to changes in the general purchasing power of those dollars.

168. The unit of measure principle is applied together with the other pervasive measurement principles. Costs are therefore measured in terms of the number of dollars initially invested in assets. If moderate inflation or deflation persists for several years or if substantial inflation or deflation occurs over short periods, the general purchasing power of the dollars in which expenses are measured may differ significantly from the general purchasing power of the dollars in which revenue is measured. Methods of accounting which tend to minimize this effect in the determination of periodic income—most notably the last-in, first-out method of inventory pricing and accelerated depreciation of plant and equipment—have become generally accepted and widely used in the United States. Methods of restating financial statements for general price-level changes have been used in some countries that have experienced extreme inflation but

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[48] Exceptions include the cost or market rule for inventories (see paragraph 183).

[49] See paragraph 65 for a general discussion of the term *cost*. The discussions of cost in paragraphs 65 and 164 are broader than that in Accounting Terminology Bulletin No. 4, paragraph 2, which defines only historical or acquisition cost.

are not now used in the basic financial statements in the United States.[60]

Modifying Conventions

169. The pervasive measurement principles are largely practical responses to problems of measurement in financial accounting and do not provide results that are considered satisfactory in all circumstances. Certain widely adopted conventions modify the application of the pervasive measurement principles. These modifying conventions, discussed in the following paragraphs, have evolved to deal with some of the most difficult and controversial problem areas in financial accounting. They are applied because rigid adherence to the pervasive measurement principles (1) sometimes produces results that are not considered to be desirable, (2) may exclude from financial statements some events that are considered to be important, or (3) may be impractical in certain circumstances.

170. The modifying conventions are applied through generally accepted rules that are expressed either in the broad operating principles or in the detailed principles. The modifying conventions are a means of substituting the collective judgment of the profession for that of the individual accountant.

171. *Conservatism.* Frequently, assets and liabilities are measured in a context of significant uncertainties. Historically, managers, investors, and accountants have generally preferred that possible errors in measurement be in the direction of understatement rather than overstatement of net income and net assets. This has led to the convention of conservatism, which is expressed in rules adopted by the profession as a whole such as the rules that inventory should be measured at the lower of cost and market and that accrued net losses should be recognized on firm purchase commitments for goods for inventory. These rules may result in stating net income and net assets at amounts lower than would otherwise result from applying the pervasive measurement principles.

172. *Emphasis on Income.* Over the past century businessmen, financial statement users, and accountants have increasingly tended to emphasize the importance of net income and that trend has affected the emphasis in financial accounting. Although balance sheets formerly were presented without income statements, the income statement has in recent years come to be regarded as the most important of the financial statements. Accounting principles that are deemed to increase the usefulness of the income statement are therefore sometimes adopted by the profession as a whole regardless of their effect on the balance sheet or other financial statements. For example, the last-in, first-out (LIFO) method of inventory pricing may result in balance sheet amounts for inventories that become further removed from current prices with the passage of time. LIFO, however, is often supported on the grounds that it usually produces an amount for cost of goods sold in determining net income that more closely reflects current prices. This result is believed to compensate for the effect under the LIFO method of presenting inventories in the balance sheet at prices substantially different from current prices.

173. *Application of Judgment by the Accounting Profession as a Whole.* Sometimes strict adherence to the pervasive measurement principles produces results that are considered by the accounting profession as a whole to be unreasonable in the circumstances or possibly misleading. Accountants approach their task with a background of knowledge and experience. The perspective provided by this background is used as the basis for modifying accounting treatments when strict application of the pervasive measurement principles yields results that do not appear reasonable to the profession as a whole.

174. The exception to the usual revenue realization rule for long-term construction-type contracts, for example, is justified in part because strict adherence to realization at the time of sale would produce results that are considered to be unreasonable. The judgment of the profession is that revenue should be recognized in this situation as construction progresses. Similarly, the most meaningful concept of net income in the judgment of the profession is one that includes all items of revenue and expense recorded during the period except for certain items that can be clearly identified with prior periods under carefully specified conditions. Extraordinary items are segregated in the current income statement so that their effects can be distinguished. Also, avoiding undue effects on the net income of a single period is judged by the profession to be important in certain circumstances.

[60] Accounting Principles Board Statement No. 3, *Financial Statements Restated for General Price-Level Changes,* issued in June 1969, recommends supplementary disclosure of general price-level information.

For example, actuarial gains and losses recognized in accounting for pension cost may be spread over the current year and future years.

CHAPTER 7 Generally Accepted Accounting Principles—Broad Operating Principles

175. The broad operating principles guide in selecting, measuring, and reporting events in financial accounting. They are grounded in the pervasive principles discussed in Chapter 6 and are applied to specific situations through the detailed principles discussed in Chapter 8. The broad operating principles are broader and less specific than the detailed principles. For example, the detailed principle of first-in, first-out inventory pricing is one application of the broad operating principles of product cost determination and asset measurement, and straight-line depreciation is one of the detailed principles through which the broad operating principles that deal with systematic and rational expense allocation are applied. Although the broad operating principles are more specific than the pervasive principles, they are also generalizations. Consequently, exceptions to the broad operating principles may exist in the detailed principles through which they are applied.

176. The financial accounting process consists of a series of operations that are carried out systematically in each accounting period. The broad operating principles guide these operations. The operations are listed separately although they overlap conceptually and some of them may be performed simultaneously:

(1) *Selecting* the events. Events to be accounted for are identified. Not all events that affect the economic resources and obligations of an enterprise are, or can be, accounted for when they occur.

(2) *Analyzing* the events. Events are analyzed to determine their effects on the financial position of an enterprise.

(3) *Measuring* the effects. Effects of the events on the financial position of the enterprise are measured and represented by money amounts.

(4) *Classifying* the measured effects. The effects are classified according to the individual assets, liabilities, owners' equity items, revenue, or expenses affected.

(5) *Recording* the measured effects. The effects are recorded according to the assets, liabilities, owners' equity items, revenue, and expenses affected.

(6) *Summarizing* the recorded effects. The amounts of changes recorded for each asset, liability, owners' equity item, revenue, and expense are summed and related data are grouped.

(7) *Adjusting* the records. Remeasurements, new data, corrections, or other adjustments are often required after the events have been initially recorded, classified, and summarized.

(8) *Communicating* the processed information. The information is communicated to users in the form of financial statements.

The broad operating principles, which guide these eight operations, are divided into (1) principles of selection and measurement and (2) principles of financial statement presentation.

PRINCIPLES OF SELECTION AND MEASUREMENT

177. The principles of selection and measurement are conventions that (1) guide selection of events to be accounted for by an enterprise, (2) determine how selected events affect the assets, liabilities, owners' equity, revenue, and expenses of the enterprise, and (3) guide assignment of dollar amounts to the effects of these events. They are classified in this chapter according to the types of economic events that affect the economic resources, economic obligations, and residual interests of enterprises, as discussed in Chapter 3 (see paragraph 62). The types of events are

I. External Events
   A. Transfers of resources or obligations to or from other entities:
      1. Exchanges (reciprocal transfers)
      2. Nonreciprocal transfers
         a. Transfers between an enterprise and its owners
         b. Nonreciprocal transfers between an enterprise and entities other than owners
   B. External events other than transfers

II. Internal Events
   A. Production
   B. Casualties

Each type of event is explained briefly in the list of principles in paragraphs 181 to 185 and more fully in paragraph 62.

178. Additional principles other than those that guide recognition of events govern accounting for those assets and liabilities that are not resources and obligations (see paragraph 132) and the related revenue and expenses.

Measurement Bases

179. Four measurement bases are currently used in financial accounting: (1) price in a past exchange of the enterprise (historical cost), which is the primary basis of measurement in financial accounting and is usually used in measuring inventory, plant and equipment, and many other assets, (2) price in a current purchase exchange, used, for example, in applying the lower of cost and market rule to inventories, (3) price in a current sale exchange, which may be used, for example, in measuring precious metals that have a fixed monetary price with no substantial cost of marketing, and (4) price based on future exchanges, used, for example, to estimate future costs when revenue is recognized on the percentage-of-completion basis. The measurement bases are described more fully in paragraph 70.

STATEMENT OF THE PRINCIPLES OF SELECTION AND MEASUREMENT

180. The principles of selection and measurement are presented in three sections:

1. The principles of selection of events and the principles of measurement (assignment of dollar amounts) are presented together for each type of event in paragraphs 181 to 185. Principles of selection (S-1 to S-7) and measurement (M-1 to M-7) that deal with the same items are identified by the same number (e. g., S-4 and M-4). Other important principles that constitute amplifications of or exceptions to the general rule are listed under it and identified with the general principle (e. g., S-4A). The statement of a principle is followed by a short discussion if further clarification is needed.
2. Principles that govern accounting for those assets and liabilities that are not resources or obligations are discussed in paragraph 186.
3. The principles (E-1 to E-10) of determination of the effects of events on the basic elements are presented in paragraph 187.

Principles That Guide Selection of Events and Assignment of Dollar Amounts

I. *External Events*

A. *Transfers of Resources or Obligations to or from Other Entities*

181. 1. *Exchanges* are reciprocal transfers between the enterprise and other entities that involve obtaining resources or satisfying obligations by giving up other resources or incurring other obligations. Exchanges may take place over time rather than at points of time (for example, accumulations of interest and rent).

S-1. *Exchanges recorded.* Exchanges between the enterprise and other entities (enterprises or individuals) are generally recorded in financial accounting when the transfer of resources or obligations takes place or services are provided.

M-1. *Exchange prices.* The effects of exchanges on assets, liabilities, revenue, and expenses are measured at the prices established in the exchanges.

S-1A. *Acquisitions of assets.* Resources acquired in exchanges are recorded as assets of the enterprise. Some assets that are not carried forward to future periods are immediately charged to expense (see S-6C).

M-1A. *Acquisition cost of assets.* Assets acquired in exchanges are measured at the exchange price, that is, at acquisition cost. Money and money claims acquired are measured at their face amount or sometimes at their discounted amount. *Discussion.* Cash, accounts receivable, and other short-term money claims are usually measured at their face amount. A long-term non-interest bearing note receivable is measured at its discounted amount.

M-1A(1). *Fair value.* In exchanges in which neither money nor promises to pay money are exchanged, the assets acquired are generally measured at the fair value of the assets given up. However, if the fair value of the assets received is more clearly evident, the assets acquired are measured at that amount.

Discussion. Fair value is the approximation of exchange price in transfers in which money or money claims are not involved. Similar exchanges are used to approximate what the exchange price would have been if an exchange for money had taken place. The recorded amount (as distinguished from the fair value) of assets given up in a trade is generally not used to measure assets acquired.

M-1A(2). *Acquisition of a group of assets in one exchange.* A group of assets acquired in a single exchange is measured at the exchange price. The total price is allocated to the individual assets based on their relative fair values.

Discussion. Fair value of assets acquired is used primarily as a device for allocating total cost, not as the measurement basis of the assets acquired.

M-1A(3). *Acquisition of a business in an exchange.* A business acquired in an exchange is measured at the exchange price. Each individual asset acquired (other than goodwill) is measured at its fair value. If the total exchange price exceeds the amounts assigned to the individual assets, the excess is recorded as goodwill. If the total amount assigned to individual assets exceeds the exchange price, the difference is recorded as a reduction of the amounts assigned to the assets (also see S-2A and S-2B).

S-1B. *Dispositions of assets.* Decreases in assets are recorded when assets are disposed of in exchanges.

M-1B. *Asset dispositions measured.* Decreases in assets are measured by the recorded amounts that relate to the assets. The amounts are usually the historical or acquisition costs of the assets (as adjusted for amortization and other changes).

Discussion. In partial dispositions measurement of the amount removed is governed by detailed principles (e.g., first-in, first-out; last-in, first-out; and average cost for inventories) that are based on the presumed "flow" of goods or the presumed "flow" of costs.

S-1C. *Liabilities recorded.* Liabilities are recorded when obligations to transfer assets or provide services in the future are incurred in exchanges.

M-1C. *Amount of liabilities.* Liabilities are measured at amounts established in the exchanges, usually the amounts to be paid, sometimes discounted.

Discussion. Conceptually, a liability is measured at the amount of cash to be paid discounted to the time the liability is incurred. Most short-term liabilities are simply measured at the amount to be paid. Discounted present values are often used if the obligations require payments at dates that are relatively far in the future. Pension obligations and liabilities under capitalized long-term leases are measured at discounted amounts. Bonds and other long-term liabilities are in effect measured at the discounted amount of the future cash payments for interest and principal. The difference between the recorded amount of a liability and the amounts to be paid is amortized over the periods to maturity.

S-1D. *Liability decreases.* Decreases in liabilities are recorded when they are discharged through payments, through substitution of other liabilities, or otherwise.

M-1D. *Liability decrease measured.* Decreases in liabilities are measured by the recorded amounts that relate to the liabilities. A partial discharge of liabilities is measured at a proportionate part of the recorded amount of the liabilities.

S-1E. *Commitments.* Agreements for the exchange of resources in the future that at present are unfulfilled commitments on both sides are not recorded until one of the parties at least partially fulfills its commitment, except that (1) some leases and (2) losses on firm commitments are recorded.

Discussion. An exception to the general rule for recording exchanges is made for most executory contracts. An exchange of promises between the contracting parties is an exchange of something of value, but the usual view in accounting is that the promises are offsetting and nothing need be recorded until one or both parties at least partially perform(s) under the contract. The effects of some executory contracts, however, are recorded, for example, long-term leases that are recorded as assets by the lessee with a corresponding liability (see discussion after M-1C).

S-1F. *Revenue from exchanges.* Revenue is recorded when products are sold, services are provided, or enterprise resources are used by others. Revenue is also recorded when an enterprise sells assets other than products (usually presented as part of a gain or loss—see paragraph 198).

M-1F. *Revenue measurement.* Revenue from exchanges is initially measured at prices established in the exchanges. The revenue amounts are reduced (or expenses recorded) for discounts, returns, and allowances.

Discussion. Revenue is usually recognized at the time of exchanges in which cash is received or new claims arise against other entities. However, exceptions are made, for example, for certain products that have an assured selling price (see S-6D) and long-term construction-type contracts (see S-6E). Revenue is not recognized on purchases.

S-1F(1). *Recognizing revenue and expenses if proceeds are collectible over a long period without reasonable assurance of collection.* The terms of an exchange transaction or other conditions related to receivables collectible over a long period may preclude a reasonable estimate of the collectibility of the receivables. Either an installment method or a cost recovery method of recognizing revenue and expenses may be used as long as collectibility is not reasonably assured.

M-1F(1). *Measuring revenue and expenses on installment or cost recovery methods.* Under both installment and cost recovery methods the proceeds collected measure revenue. Under an installment method expenses are measured at an amount determined by multiplying the cost of the asset sold by the ratio of the proceeds collected to the total selling price. Under a cost recovery method, expenses are measured at the amounts of the proceeds collected until all costs have been recovered.

S-1G. *Expenses directly associated with revenue from exchanges.* Costs of assets sold or services provided are recognized as expenses when the related revenue is recognized (see S-1F).

M-1G. *Expense measurement.* Measurement of expenses directly associated with revenue recognized in exchanges is based on the recorded amount (usually acquisition cost) of the assets that leave the enterprise or the costs of the services provided (see S-6A(1) for a discussion of product and service costs).

Discussion. Revenue is usually accompanied by related expenses. For example, sale of a product leads to recording of revenue from the sale and an expense for the cost of the product sold. If an asset other than a normal product, such as a building, is sold, the undepreciated cost of the asset is an expense to be subtracted from the revenue on the sale.

182. 2. *Nonreciprocal transfers* are transfers in one direction of resources or obligations, either from the enterprise to other entities or from other entities to the enterprise.

a. *Transfers between an enterprise and its owners.* Examples are investments of resources by owners, declaration of cash or property dividends, acquisition of treasury stock, and conversion of convertible debt.

S-2. *Owners' investments and withdrawals recorded.* Transfers of assets or liabilities between an enterprise and its owners are recorded when they occur.

M-2. *Owners' investments and withdrawals measured.* Increases in owners' equity are usually measured by (a) the amount of cash received, (b) the discounted present value of money claims received or liabilities cancelled, or (c) the fair value of noncash assets received.[81] Decreases in owners' equity are usually measured by (a) the amount of cash paid, (b) the recorded amount of noncash assets transferred, or (c) the discounted present value of liabilities incurred.

Discussion. Measurement of owners' investments is generally based on the fair value of the assets or the discounted present value of liabilities that are transferred. The market value of stock issued may be used to establish an amount at which to record owners' investments but

[81] The fair value of assets received is often measured by the fair value of the shares of stock issued.

this amount is only an approximation when the fair value of the assets transferred cannot be measured directly.

S-2A. *Acquisition of a business as a whole through issuance of stock.* The acquisition of a business as a whole by an enterprise through the issuance of stock is recorded when it occurs. (See S-2B for a discussion of poolings of interests.)

M-2A. *Acquisition of a business through issuance of stock measured.* A business acquired through issuance of stock is measured at the fair value of the business acquired. Each individual asset acquired (other than goodwill) is measured at its fair value. If the fair value of the whole business exceeds the amounts assigned to the individual assets, the excess is recorded as goodwill. If the total assigned to individual assets exceeds the fair value of the whole business, the difference is recorded as a reduction of the amounts assigned to the assets.

S-2B. *Poolings of interests.* Business combinations effected by issuance of voting common stock that also meet other specified criteria are accounted for as poolings of interests and not as acquisitions of one business by another. A business combination accounted for as a pooling of interests is accounted for when it occurs.

M-2B. *Poolings of interests measured.* The assets, liabilities, and elements of owners' equity of the separate companies generally become the assets, liabilities, and elements of owners' equity of the combined corporation. They generally are measured at the time of combination by the combined corporation at the amounts at which they were then carried by the separate companies. The revenue and expenses of the combined corporation for the period in which the companies are combined include the revenue and expenses of the separate companies from the beginning of the period to the date of combination. Financial statements for prior periods presented in reports of the combined corporation combine the financial statements of the separate companies.

S-2C. *Investments of noncash assets by founders or principal stockholders of a corporation.* Transfers of noncash assets to a corporation by its founders or principal stockholders are recorded when they occur.

M-2C. *Founders' or principal stockholders' investments of noncash assets measured.* Transfers of noncash assets to a corporation by its founders or principal stockholders are sometimes measured at their costs to the founders or principal stockholders rather than at their fair value at the date of transfer.

b. *Nonreciprocal transfers between an enterprise and entities other than owners.* Examples are gifts and donations, taxes, loss of a negligence lawsuit, imposition of fines, and theft.

S-3. *Nonreciprocal transfers recorded.* Nonreciprocal transfers with other than owners are recorded when assets are acquired (except that some noncash assets received as gifts are not recorded), when assets are disposed of or their loss is discovered, or when liabilities come into existence or are discovered.

M-3. *Nonreciprocal transfers measured.* Those noncash assets received in nonreciprocal transfers with other than owners that are recorded are measured at their fair value on the date received. Noncash assets given are usually accounted for at their recorded amount. Liabilities imposed are measured at the amount to be paid, sometimes discounted.

183. B. *External events other than transfers of resources or obligations to or from other entities.* Examples are changes in specific prices of enterprise assets, changes in interest rates, general price-level changes, technological changes caused by outside entities, and damage to enterprise assets caused by others.

S-4. *Favorable external events other than transfers generally not recorded.* External events other than transfers that increase market prices or utility of assets or decrease amounts required to discharge liabilities are generally not recorded when they occur. Instead their effects are usually reflected at the time of later exchanges.

M-4. *Retention of recorded amounts.* Assets whose prices or utility are increased by external events other than transfers are normally retained in the accounting records at their recorded amounts until they are exchanged. Liabilities that can be satisfied for less than their recorded amounts because of external events generally are retained in the records at their recorded amounts until they are satisfied.

S-4A. *Some favorable events recorded.* Examples of the few exceptions to principle S-4 are (1) increases in market prices of marketable securities held by investment companies and (2) decreases in the amounts required currently to satisfy liabilities to provide services or deliver resources other than U. S. dollars, for example, foreign currency obligations and obligations under warranties.

M-4A. *Measuring favorable events.* Recorded increases in market prices are measured by the difference between the recorded amount of the securities and the higher market price. Recorded decreases in liabilities are measured by the difference between the recorded amounts of the liabilities and the lower amounts estimated to be required to satisfy them.

S-5. *Unfavorable external events other than transfers recorded.* Certain unfavorable external events, other than transfers, that decrease market prices or utility of assets or increase liabilities are recorded.

M-5. *Measuring unfavorable events.* The amounts of those assets whose decreased market price or utility is recorded are adjusted to the lower market price or recoverable cost resulting from the external event.

Discussion. Recording unfavorable external events other than transfers varies depending on the type of asset or liability and is governed by specific rules. The major rules are described below.

S-5A. *Cost or market rule for inventories.* A loss is recognized by application of the rule of lower of cost and market to inventories when their utility is no longer as great as their cost.

M-5A. *Measuring inventory losses under the cost or market rule.* Replacement price is used in measuring the decline in price of inventory except that the recorded decline should not result in carrying the inventory at an amount that (1) exceeds net realizable value or (2) is lower than net realizable value reduced by an allowance for an approximately normal profit margin.

S-5B. *Decline in market price of certain marketable securities.* If market price of marketable securities classified as current assets is less than cost and it is evident that the decline is not due to a temporary condition a loss is recorded when the price declines.

M-5B. *Measuring losses from decline in price of marketable securities.* The loss on a price decline of marketable securities is measured by the difference between the recorded amount and the lower market price.

S-5C. *Obsolescence.* Reductions in the utility of productive facilities caused by obsolescence due to technological, economic, or other change are usually recognized over the remaining productive lives of the assets. If the productive facilities have become worthless the entire loss is then recognized.

M-5C. *Measuring obsolescence.* Obsolescence of productive facilities is usually measured by adjusting rates of depreciation, depletion, or amortization for the remaining life (if any) of the assets. If productive facilities have become worthless, unamortized cost is recognized as a current loss.

Discussion. In unusual circumstances persuasive evidence may exist of impairment of the utility of productive facilities indicative of an inability to recover cost although the facilities have not become worthless. The amount at which those facilities are carried is sometimes reduced to recoverable cost and a loss recorded prior to disposition or expiration of the useful life of the facilities.

S-5D. *Damage caused by others.* The effects of damage to enterprise assets caused by others are recorded when they occur or are discovered.

M-5D. *Measuring damage caused by others.* When enterprise assets are damaged by others, asset amounts are written down to recoverable costs and a loss is recorded.

S-5E. *Decline in market prices of noncurrent assets generally not recorded.* Reductions in the market prices of noncurrent assets are generally not recorded until the assets are disposed of or are determined to be worthless.

M-5E. *Retention of recorded amount.* Noncurrent assets whose market prices have declined are generally retained in accounting records at their recorded amounts until they are disposed of or have become worthless.

Discussion. In unusual circumstances a reduction in the market price of securities classified as noncurrent assets may provide persuasive evidence of an inability to recover cost although the securities have not become worthless.

The amount at which those securities are carried is sometimes reduced and a loss recognized prior to disposition of the securities.

S-5F. *Increases in amounts required to liquidate liabilities other than those payable in U. S. dollars recorded.* Increases in the amounts required currently to satisfy liabilities to provide services or deliver resources other than U. S. dollars, for example, foreign currency obligations and obligations under warranties, are often recorded. Increases in amounts required currently to liquidate liabilities payable in U. S. dollars because of changes in interest rates or other external factors are generally not recorded until the liabilities are liquidated, converted, or otherwise disposed of.

M-5F. *Liability increases measured.* Recorded increases in liabilities from external events other than transfers are measured at the difference between the recorded amount of the liabilities and the higher amounts estimated to be required to satisfy them.

II. *Internal Events*

184. A. *Production.* Production in a broad sense is the economic process by which inputs of goods and services are combined to produce an output of product which may be either goods or services. Production in this sense is therefore *not* restricted to manufacturing operations, but includes activities such as merchandising, transporting, and holding goods.

S-6. *Production recorded.* Utility added to assets by the internal profit-directed activities of the enterprise is generally not recorded at the time of production. Instead, historical or acquisition costs, including costs of the production process, are shifted to different categories of assets or to expenses as events in the enterprise indicate that goods and services have been used (either partially or completely) in the production operations of the period. The costs that continue to appear in asset categories are deducted from revenue when the products or services to which they have been related are sold at a later date (see S-1G).

M-6. *Production measurement.* Utility created by production is generally not measured at the time of production. Instead, previously recorded amounts (usually acquisition costs) are shifted or allocated between asset categories or between activities or periods in a systematic and rational manner.

Discussion. Accounting for production encompasses much of the internal accounting for the enterprise. Accounting to determine costs of manufacturing products and providing services (cost accounting) is a part of production accounting in general. The purpose of production accounting is to relate costs to revenue when the product is sold or services provided or to relate costs to particular accounting periods.

S-6A. *Costs of manufacturing products and providing services.* Costs of manufacturing products and providing services during a period include (1) costs of assets that are completely used during the period in manufacturing products and providing services and (2) allocated portions of the costs of assets that are partially used during the period in manufacturing products and providing services, assigned in a systematic and rational manner to those activities.

M-6A. *Measuring costs of manufacturing products and providing services.* Costs of manufacturing products and providing services are measured at the recorded amounts (usually acquisition costs) of assets used directly and by allocations in a systematic and rational manner of recorded amounts of assets used indirectly.

Discussion. Cost accounting often involves shifts and allocations of acquisition costs. The shifts and allocations are based on observed or assumed relationships between the assets used and the activities of manufacturing products or providing services. An example of a shift to a different category is the shift of costs from raw materials inventory to work in process inventory. Examples of allocated costs are overhead costs such as power, indirect labor, repair costs, and depreciation of plant and equipment.

S-6A(1). *Product and service costs.* Costs assigned to products and services provided are those costs of manufacturing products and providing services that are considered productive, including direct costs and indirect costs (absorbed overhead). Costs of manufacturing products and providing services for a period that are not assigned to product or service costs are charged to expense during the period, for example, unabsorbed overhead.

M-6A(1). *Measuring product and service costs.* Product and service costs are measured by the sum of productive costs of manufacturing products and providing services assigned to units of product or service in a rational and systematic manner.

S-6B. *Expenses from systematic and rational allocation.* Some expenses are associated with accounting periods by allocating costs of assets over their useful lives.

M-6B. *Determination of expenses by systematic and rational allocation.* These expenses are allocations of the recorded amount of assets in a systematic and rational manner to the period or periods of the assets' lives.

Discussion. If all the benefits of an asset are related to one period, the recorded amount of the asset is charged as expense in that period. If the asset will benefit several periods, the recorded amount is charged to expense in a systematic and rational manner over the periods involved. Depreciation, depletion, and amortization of long-lived assets are examples of amounts allocated to periods as expenses (excluding amounts allocated to costs of manufacturing products and providing services, see S-6A).

S-6C. *Expenses recognized immediately.* The costs of some assets are charged to expense immediately on acquisition.

M-6C. *Measurement of expenses recognized immediately.* Expenses from immediate recognition are measured at the acquisition prices of the assets acquired.

Discussion. Enterprises never acquire expenses per se; they always acquire assets. Costs may be charged to expenses in the period goods or services are acquired either under this principle of immediate recognition or, if they only benefit the period in which they are acquired, under the principle of systematic and rational allocation (see S-6B). Examples of costs that often are charged to expense immediately are salaries paid to officers and payments for advertising.

S-6D. *Revenue at completion of production.* Revenue may be recorded at the completion of production of precious metals that have a fixed selling price and insignificant marketing costs. Similar treatment may also be accorded certain agricultural, mineral, and other products characterized by inability to determine unit acquisition costs, immediate marketability at quoted prices that cannot be influenced by the producer, and unit interchangeability.

M-6D. *Revenue measured by net realizable value of product.* Revenue recorded at completion of production is measured by the net realizable value of the product.

Discussion. Recognition of revenue at completion of production is an exception to principles S-1F and S-6. The net realizable value of product is its selling price less expected costs to sell.[53]

S-6E. *Revenue as production progresses.* Revenue from cost-plus-fixed-fee and long-term construction-type contracts is recognized as production progresses using the percentage-of-completion method if the total cost and the ratio of performance to date to full performance can be reasonably estimated and collection of the contract price is reasonably assured. When the current estimate of total contract costs indicates a loss on long-term construction-type contracts, in most circumstances provision is made for the loss on the entire contract.

M-6E. *Measuring revenue as production progresses.* Under the cost-plus-fixed-fee contracts, revenue recognized as production progresses includes either reimbursable costs and an allocated portion of the fee or an allocated portion of the fee alone. Under long-term construction-type contracts, revenue recognized as production progresses is measured at an allocated portion of the predetermined selling price. Product or service cost is subtracted from revenue as an expense as production progresses for long-term construction-type contracts and for those cost-plus-fixed-fee contracts for which recorded revenue includes reimbursable costs.

[53] See paragraph 152, footnote 45, for a discussion of income statement treatment of revenue recognized at completion of production.

Discussion. Recognition of revenue as production progresses is another exception to principles S-1F and S-6.

185. B. *Casualties.* Casualties are sudden, substantial, unanticipated reductions in enterprise assets not caused by other entities. Examples are fires, floods, and abnormal spoilage.

S-7. *Casualties.* Effects of casualties are recorded when they occur or when they are discovered.

M-7. *Measuring casualties.* When casualties occur or are discovered, asset amounts are written down to recoverable costs and a loss is recorded.

Accounting for Those Assets and Liabilities That Are Not Resources or Obligations

186. Accounting for those assets and liabilities that are not resources or obligations (see paragraph 132) and the related revenue and expenses is governed by detailed principles, for example, principles for accounting for deferred federal income taxes in APB Opinion No. 11. The principles are generally related to the modifying conventions, especially emphasis on income (see paragraphs 169 to 174).

Principles That Determine Effects on Assets, Liabilities, Owners' Equity, Revenue, and Expenses of an Enterprise

187. Principles (E-1 to E-10) that summarize the effects of selection and measurement on the basic elements of financial accounting are related to changes in assets, liabilities, owners' equity, revenue, and expenses rather than to types of events. The first of these principles recognizes the interrelated effects of events.

E-1. *Dual effects.* Each recorded event affects at least two items in the financial accounting records. The double entry system of recording is based on this principle.

In the following principles, the changes in assets, liabilities, owners' equity, revenue, and expenses that are recognized in conformity with generally accepted accounting principles are listed, together with some indication of the dual effect. Recognized changes are derived from the preceding principles of selection of events and assignment of dollar amounts.

E-2. *Increases in assets* arise from (1) exchanges in which assets are acquired, (2) investments of assets in the enterprise by owners, (3) nonreciprocal transfers of assets to an enterprise by other than owners, (4) shifts of costs to different asset categories in production, and, occasionally, (5) increases in amounts ascribed to produced assets. Increases in assets rarely arise from external events other than transfers.

In exchanges, asset increases may be accompanied by decreases in other assets (e.g., a purchase for cash), increases in liabilities (e.g., a purchase on account), or recognition of revenue (e.g., a sale for cash). In production, costs may be shifted from one asset classification to another with no change in total assets. If production increases are recorded (e.g., at the completion of production of precious metals), the increase is recognized as revenue or reduction of expenses. Increases in the market prices of securities held by investment companies is an example of asset increases recognized on external events other than transfers.

E-3. *Decreases in assets* arise from (1) exchanges in which assets are disposed of, (2) withdrawals of assets from the enterprise by owners, (3) nonreciprocal transfers of assets from the enterprise other than to owners, (4) certain external events other than transfers that reduce the market price or utility of assets, (5) shifts or allocations of costs to different asset categories or to expense in production, and (6) casualties.

In exchanges, asset decreases may be accompanied by increases in other assets (e.g., a purchase for cash or a sale for cash or on account), decreases in liabilities (e.g., payment of a debt), or increases in expenses. An increase of expenses in an exchange may result if an asset acquired is used up almost immediately or if future benefits of an expenditure cannot be determined and it is therefore written off to expense immediately. The sale of products results in a decrease in product held by the enterprise and reduces an asset and increases an expense.

E-4. *Increases in liabilities* arise from (1) exchanges in which liabilities are incurred, (2) transfers between an enterprise and its owners (dividend declaration), and (3) nonreciprocal transfers with other than owners in which liabilities arise.

In exchanges, liability increases may be accompanied by decreases in other liabilities (e.g., a note given on an account payable), increases in assets (e.g., a purchase on account), or an expense (e.g., office salaries incurred but unpaid).

E-5. *Decreases in liabilities* arise from (1) exchanges in which liabilities are reduced, (2) transfers between an enterprise and its owners (debt converted into capital stock), and (3) nonreciprocal transfers with other than owners in which liabilities are reduced (forgiveness of indebtedness).

In exchanges, liability decreases may be accompanied by increases in other liabilities (e.g., a note given on an account payable), decreases in assets (e.g., payment of an account), or revenue (e.g., goods delivered or services rendered to satisfy a customer prepayment).

E-6. *Increases in owners' equity* arise from (1) investments in an enterprise by its owners, (2) the net result of all revenue and expenses recognized during a period (net income), and (3) nonreciprocal transfers to an enterprise from other than owners (gifts and donations). Owners' equity may also be increased by prior period adjustments.

E-7. *Decreases in owners' equity* arise from (1) transfers from an enterprise to its owners (dividends, treasury stock acquisitions), and (2) net losses for a period. Owners' equity may also be decreased by prior period adjustments.

E-8. *Revenue* arises primarily from exchanges. Occasionally revenue arises from production, and rarely from nonreciprocal transfers and from external events other than transfers.

Revenue from exchanges is usually accompanied by asset increases but may be accompanied by decreases in liabilities ("unearned revenue").

E-9. *Expenses* arise from (1) exchanges, (2) nonreciprocal transfers with other than owners, (3) external events other than transfers, (4) production, and (5) casualties.

Expenses that arise in exchanges are costs associated directly with revenue recognized when assets are sold or services are provided [including product and service costs, see S-6A(1)]. Expenses that arise in production are (1) costs of manufacturing products and providing services not included in product or service costs (for example, unabsorbed overhead), (2) expenses from systematic and rational allocation of the cost of assets over their useful lives (excluding amounts allocated to costs of manufacturing products and providing services, see S-6A), (3) expenses recognized immediately on the acquisition of goods and services, and (4) costs of products for which revenue is recognized at the completion of production or as production progresses (see S-6D and S-6E).

E-10. *Effects of accounting for assets and liabilities that are not resources or obligations* (see paragraphs 132 and 186). Accounting for these assets and liabilities results in increases and decreases in assets and increases and decreases in liabilities. The income statement effects are usually confined to increases and decreases in expenses.

PRINCIPLES OF FINANCIAL STATEMENT PRESENTATION

188. The principles of financial statement presentation guide the communication of the information provided by the financial accounting process. They are related to the principles of selection and measurement and the pervasive principles but are not derived directly from them. The presentation principles are more closely related to the objectives of financial accounting and financial statements. The general objectives that deal with the type of information to be provided (for example, reliable information about economic resources and obligations and economic progress) and the qualitative objectives based on characteristics of useful information (such as comparability, completeness, and understandability) directly influence the content of some of the presentation principles. The basic features of financial accounting, particularly accounting entity, approximation, and fundamentally related financial statements, also influence these principles.

Fair Presentation in Conformity with Generally Accepted Accounting Principles

189. The qualitative standard of *fair presentation in conformity with generally accepted accounting principles* of financial position and results of operations is particularly important in evaluating financial presentations. This standard guides preparers of financial statements and is the subjective benchmark against which independent public accountants judge the propriety of the financial

accounting information communicated. Financial statements "present fairly in conformity with generally accepted accounting principles" if a number of conditions are met: (1) generally accepted accounting principles applicable in the circumstances have been applied in accumulating and processing the financial accounting information, (2) changes from period to period in generally accepted accounting principles have been appropriately disclosed, (3) the information in the underlying records is properly reflected and described in the financial statements in conformity with generally accepted accounting principles, and (4) a proper balance has been achieved between the conflicting needs to disclose important aspects of financial position and results of operations in accordance with conventional concepts and to summarize the voluminous underlying data into a limited number of financial statement captions and supporting notes.

STATEMENT OF THE PRINCIPLES OF FINANCIAL STATEMENT PRESENTATION

190. The principles of financial statement presentation guide reporting of financial accounting information. They are conventional and subject to change in the same manner as the principles of selection and measurement. Eleven principles (R-1 to R-11) of financial statement presentation are stated; two are amplified by related principles; several are followed by explanations of their characteristics or applications.

191.

R-1. *Basic financial statements.* A balance sheet, a statement of income, a statement of changes in retained earnings, disclosure of changes in other categories of stockholders' equity, and related notes is the minimum presentation required to present fairly the financial position and results of operations of an enterprise in conformity with generally accepted accounting principles.

The basic financial statements are usually presented for two or more periods to enhance their usefulness. Historical summaries are also often presented. Other information may be provided as supplementary to the basic statements, for example, a statement of source and application of funds, data as to revenue and net income by lines of business, information regarding physical output, and financial statements restated for changes in the general price level. These kinds of information, however, are not now considered necessary for a fair presentation of financial position and results of operations in conformity with generally accepted accounting principles.

192.

R-2. *Complete balance sheet.* The balance sheet or statement of financial position should include and properly describe all assets, liabilities, and classes of owners' equity as defined by generally accepted accounting principles.

193.

R-3. *Complete income statement.* The income statement of a period should include and properly describe all revenue and expenses as defined by generally accepted accounting principles.

Under narrowly specified conditions an income statement should exclude a few items that represent adjustments of prior periods' net income.

194.

R-4. *Accounting period.* The basic time period for which financial statements are presented is one year; "interim" financial statements are commonly presented for periods of less than a year.

195.

R-5. *Consolidated financial statements.* Consolidated financial statements are presumed to be more meaningful than the separate statements of the component legal entities. Consolidated statements are usually necessary for fair presentation in conformity with generally accepted accounting principles if one of the enterprises in a group directly or indirectly owns over 50% of the outstanding voting stock of the other enterprises.

Consolidated financial statements present the financial position and results of operations of a parent company and its subsidiaries essentially as if the group were a single enterprise comprised of branches or divisions. The resulting accounting entity is an economic rather than a legal unit, and its financial statements are considered to reflect the substance of the combined economic relationships to an extent not possible by merely providing the separate financial statements of the corporate entities comprising the group.

196.

R-6. *Equity basis.* Domestic unconsolidated subsidiaries should be presented in consolidated financial statements on the equity basis. Foreign unconsolidated subsidiaries and investments in 50% owned companies and certain jointly owned companies may be presented on the equity basis.

Under the equity basis, consolidated net income during a period includes the parent company's proportionate share of the net income reported by the subsidiary or affiliate for the period (subsequent to acquisition in the period of acquisition). The effect is that net income for the period and owners' equity at the end of the period are the same as if the companies presented on the equity basis had been consolidated. Dividends received are treated as adjustments of the amount of the investment under the equity basis.

197.

R-7. *Translation of foreign balances.* Financial information about the foreign operations of U. S. enterprises should be "translated" into U. S. dollars by the use of conventional translation procedures that involve foreign exchange rates.

198.

R-8. *Classification and segregation.* Separate disclosure of the important components of the financial statements is presumed to make the information more useful. Examples in the income statement are sales or other source of revenue, cost of sales, depreciation, selling and administrative expenses, interest expense, and income taxes. Examples in the balance sheet are cash, receivables, inventories, plant and equipment, payables, and categories of owners' equity.

Owners' equity of corporations is conventionally classified into categories including par or stated amount of capital stock, additional paid-in capital, and retained earnings. Net income or net loss, prior period adjustments, dividends, and certain transfers to other categories of owners' equity are among the changes in owners' equity that affect retained earnings.

R-8A. *Working capital.* Disclosure of components of working capital (current assets less current liabilities)[53] is presumed to be useful in manufacturing, trading, and some service enterprises. Current assets and current liabilities are distinguished from other assets and liabilities.

Disclosure of working capital is normally accomplished by classifying current assets and liabilities separately. Current assets include cash and other assets that are reasonably expected to be realized in cash or sold or consumed during the normal operating cycle of the business or within one year if the operating cycle is shorter than one year. Current liabilities include those expected to be satisfied by either the use of assets classified as current in the same balance sheet or the creation of other current liabilities, or those expected to be satisfied within a relatively short period of time, usually one year. (See Accounting Research Bulletin No. 43, Chapter 3A.)

R-8B. *Offsetting.* Assets and liabilities in the balance sheet should not be offset unless a legal right of setoff exists.

R-8C. *Gains and losses.* Revenue and expenses from other than sales of products, merchandise, or services may be separated from other revenue and expenses and the net effects disclosed as gains or losses.[54]

Revenue and expense result from dispositions of assets other than products of the enterprise as well as from sales of products or services. For disclosure purposes, revenue (proceeds received) and expenses (cost of assets relinquished) on dispositions of assets other than products are separated from other revenue and expenses and the net amounts (revenue less expense) are shown as gains or losses. If these gains or losses are not material in amount they may be combined with other income statement amounts.

Other examples of gains and losses are sizable write-downs of inventories, receivables, and capitalized research and development costs, sizable gains and losses on sale of temporary investments, and gains and losses on foreign currency devaluations. Gains and losses include items that are of a character typical of the customary business activities of the entity, which may be disclosed separately if their effects are material, and extraordinary gains and losses,

[53] Because the term *working capital* is sometimes used to describe current assets alone, the difference between current assets and current liabilities is sometimes described as *net working capital.*

[54] Losses are sometimes defined in the accounting literature as expired costs that produce no revenue. "Losses" of that type are a subclassification of expenses in this Statement.

which should be presented separately (see the following principle).

R-8D. *Extraordinary items.* Extraordinary gains and losses should be presented separately from other revenue and expenses in the income statement.

Extraordinary items are of a character significantly different from the typical or customary business activities of the enterprise. They are transactions and other events of material effect that are not expected to recur frequently and that are not normally considered in evaluating the ordinary operating processes of the business. (See APB Opinion No. 9.)

R-8E. *Net income.* The net income of an enterprise for a period should be separately disclosed and clearly identified in the income statement.

Identifying the amount of the net income is considered necessary for fair presentation in conformity with generally accepted accounting principles.

199.

R-9. *Other disclosures.* In addition to informative classifications and segregation of data, financial statements should disclose all additional information that is necessary for fair presentation in conformity with generally accepted accounting principles. Notes that are necessary for adequate disclosure are an integral part of the financial statements.

Financial statements cannot provide all of the information available about an enterprise. They are essentially summaries of a large quantity of detailed information. Furthermore, the information given on the face of the statements is largely restricted to that which can be represented by a number described by a very few words. Normally information of that type needs amplification to make it most useful, and both the financial statements and the notes are necessary for adequate disclosure. In addition to the three types of disclosure specified below that are considered necessary, additional disclosures are commonly made, for example, disclosure of nonarm's-length transactions. In general, information that might affect the conclusions formed by a reasonably informed reader of the financial statements should be disclosed. Disclosure principles carry an implied responsibility to present information so that its significance is apparent to a reasonably informed reader. A mass of detailed information, overly compressed information, and language that may be a barrier to communication are unsatisfactory. Financial statements should inform the reader of matters that may affect his interpretation of them, and may provide additional information that will facilitate his understanding and use of the statements.

R-9A. *Customary or routine disclosure.* Information about measurement bases of important assets, restrictions on assets and of owners' equity, contingent liabilities, contingent assets, important long-term commitments not recognized in the body of the statements, information on terms of owners' equity and long-term debt, and certain other disclosures required by pronouncements of the Accounting Principles Board and the Committee on Auditing Procedure of the American Institute of Certified Public Accountants and regulatory bodies that have jurisdiction are necessary for full disclosure.

R-9B. *Disclosure of changes in accounting principles.* Disclosure of changes in accounting principles, practices, or the methods of applying them, together with the financial effect, is necessary.

R-9C. *Disclosure of subsequent events.* Disclosure of events that affect the enterprise directly and that occur between the date of, or end of the period covered by, the financial statements and the date of completion of the statements is necessary if knowledge of the events might affect the interpretation of the statements, even though the events do not affect the propriety of the statements themselves.

200.

R-10. *Form of financial statement presentation.* No particular form of financial statements is presumed better than all others for all purposes, and several forms are used.

201.

R-11. *Earnings per share.* Earnings per share information is most useful when furnished in conjunction with net income and its components and should be disclosed on the face of the income statement.

A single figure for earnings per share involves the same limitations of usefulness as does a single figure for net income. Unless earnings per share statistics are presented in conjunction with financial statements and with other historical information, their usefulness in evaluating past performance of an enterprise and attempting to formulate an opinion as to its future potential is limited. Furthermore, earnings per share should be disclosed for (a) income before extraordinary items, and (b) net income. Earnings per share disclosure should take into consideration matters such as changes in the number of shares outstanding, contingent changes, and possible dilution from potential conversions of convertible debentures, preferred stock, options, or warrants.

CHAPTER 8 Generally Accepted Accounting Principles—Detailed Accounting Principles

202. The detailed principles of accounting are the large body of practices and procedures that prescribe definitively how transactions and other events should be recorded, classified, summarized, and presented. They are the means of implementing the pervasive and broad operating principles discussed in Chapters 6 and 7.

203. The detailed accounting principles are not enumerated in this Statement for several reasons:

1. Many detailed accounting principles are already found in Opinions of the Accounting Principles Board and in the Accounting Research Bulletins.

2. The pervasive principles and the broad operating principles that underlie the detailed accounting principles tend to evolve slowly. The detailed principles, on the other hand, change relatively frequently. A comprehensive statement of detailed principles therefore would need continual revision to avoid becoming obsolete.

3. A comprehensive statement of detailed accounting principles would include material that the Board cannot, as practical matter, consider at this time.

204. The Opinions of the Accounting Principles Board and the Accounting Research Bulletins are the most authoritative sources of generally accepted accounting principles for members of the American Institute of Certified Public Accountants.[55] Opinions of the Accounting Principles Board and Accounting Research Bulletins deal with specific subjects but do not constitute a comprehensive list of detailed accounting principles. No comprehensive authoritative list of detailed accounting principles is presently available.[56]

205. Securities and Exchange Commission pronouncements are an important source of detailed principles in some areas. These pronouncements specify requirements for Securities and Exchange Commission reports and influence financial accounting and reporting practices. Actual accounting and reporting practices are another important source of detailed accounting principles in areas not covered by Accounting Principles Board Opinions or the Accounting Research Bulletins. Publications of professional organizations, for example Industry Audit Guides published by the American Institute of CPAs, and surveys that disclose predominant or preferred accounting practices may also provide evidence of authoritative support. On the other hand, isolated instances of actual practice cannot be regarded as authoritative.

206. Accounting textbooks and other accounting writings may also be referred to as sources of detailed accounting principles in areas that are not covered by Accounting Principles Board Opinions or the Accounting Research Bulletins. The information from these sources must be regarded as tentative. No one textbook or other writing may be regarded as authoritative in itself. The consensus of a number of writers, however, may be a good indication of existing detailed principles not covered by Accounting Principles Board pronouncements.

[55] Special Bulletin, *Disclosure of Departures From Opinions of Accounting Principles Board*, October 1964, presents recommendations adopted by Council; see especially recommendations 1, 2, and 4. *APB Accounting Principles*, published for the Institute by Commerce Clearing House, Inc., is a looseleaf service which includes all of the Opinions and Statements of the Accounting Principles Board and the Accounting Research Bulletins currently in effect and is kept up-to-date. The service is classified by subject matter and is cross-referenced and indexed.

[56] Accounting Research Study No. 7, *Inventory of Generally Accepted Accounting Principles for Business Enterprises*, by Paul Grady, is a valuable source of those detailed accounting principles that existed at the time of its publication in 1965. This is an "unofficial" source, however, because Accounting Research Studies are not pronouncements of the Accounting Principles Board or of the Institute, and the fact that the study quotes extensively from the Board Opinions and the Accounting Research Bulletins in no way changes the status of either the pronouncements or the study.

CHAPTER 9 Financial Accounting in the Future

207. Description of the environment, objectives, and basic features of financial accounting and financial statements and of broad generally accepted accounting principles has been an important objective of the Accounting Principles Board since its inception. Issuance of this Statement is a basic step in the Board's program of determining appropriate practice and narrowing areas of difference and inconsistency.

DYNAMIC NATURE OF FINANCIAL ACCOUNTING

208. Present generally accepted accounting principles are the result of an evolutionary process that can be expected to continue in the future. Changes may occur at any level of generally accepted accounting principles. The pervasive and broad operating principles are relatively stable but may change over time. Changes occur more frequently in the detailed principles used to apply broad principles to specific situations.

209. Generally accepted accounting principles change in response to changes in economic and social conditions, to new knowledge and technology, and to demands of users for more serviceable financial information. The dynamic nature of financial accounting—its ability to change in response to changed conditions—enables it to maintain and increase the usefulness of the information it provides.

BASIS FOR EVALUATION

210. Although this Statement does not specify what generally accepted accounting principles should be in the future, it is intended to provide a basis for evaluating principles and guiding changes in financial accounting. Orderly change in financial accounting is promoted by evaluation of present and proposed principles in terms of their internal consistency and practical operation and in the light of observations concerning the environment and objectives of financial accounting and financial statements.

Practical Operation and Internal Consistency of Generally Accepted Accounting Principles

211. Present generally accepted accounting principles can be analyzed to determine if they are operational and internally consistent.[87] Analysis can focus on individual principles and on their implications for and consistency with other principles. Evaluations of this type can aid in narrowing areas of difference and promoting the usefulness of financial accounting information.

The Environment

212. Generally accepted accounting principles can also be evaluated by relating the financial accounting information they produce to the economic activities that the information attempts to represent. The significant constraints placed on accounting measurement by the complexity, continuity, and joint nature of economic activities are important in this evaluation.

Objectives of Financial Accounting and Financial Statements

213. Understanding the objectives of financial accounting and financial statements (Chapter 4) is vital in evaluating and improving generally accepted accounting principles. The general objectives relate the content of financial accounting information to the interests and needs of users. The content of financial accounting information can therefore be appraised by determining the extent to which it serves these interests and needs. The qualitative objectives indicate the characteristics of useful information and thus provide criteria for appraising the usefulness of financial accounting information. The objectives are now achieved with varying degrees of success but improvement is probably possible in achieving each of them. Some objectives may conflict, however, so that improvement in one area may be at the expense of another area. Generally accepted accounting principles should therefore be evaluated to determine the degree to which the objectives are met and the extent to which present principles represent an optimum practical solution to the problem of resolving conflicts between objectives.

[87] Although consistency of principles is desirable, improving financial accounting may require changes that temporarily increase inconsistency among principles.

PROPOSALS FOR CHANGE

214. Suggestions have been made that present generally accepted accounting principles be changed (1) to eliminate differences in accounting practices that are not justified by differences in circumstances, (2) to make them more internally consistent, (3) to improve their effectiveness in accomplishing the objectives of financial accounting, and (4) to reflect more adequately the economic activities represented. These suggestions have resulted in a number of proposals in recent years which have not been fully evaluated but which, if accepted, would result in significant changes in generally accepted accounting principles and the resulting financial statements. Brief mention of some of these proposals in the following paragraphs does not, of course, imply a degree of present acceptance nor constitute a forecast of future acceptance. Reference to them in this Statement does not give them substantial authoritative support.

215. Some proposals contemplate change within the basic historical-cost-based accounting described in this Statement in connection with present generally accepted accounting principles. The proposed changes, for example, would broaden the measurement and recognition criteria so that some items, such as contracts, commitments, and leases, that are not now recorded as assets and liabilities would be included in financial statements; also, criteria would be established for associating inventory costs and the costs of long-lived productive assets (plant and equipment) with the related revenue, both to narrow the range of acceptable procedures and to reduce the necessity of making essential arbitrary choices among procedures. Although adopting these kinds of proposals would introduce significant changes, financial accounting for the most part would still rely on relating acquisition costs with revenue to determine income and on acquisition prices as the basic recorded amount of assets.

216. Other proposals contemplate more sweeping changes in the financial accounting structure or the content of financial statements. For example, they would revise the realization principle to permit accrual of increases in value of resources during production, substitute current replacement prices, current selling prices, estimated future selling prices, or discounted present-value concepts for acquisition prices as the basis of measurement, recognize changes in the general level of prices, and incorporate budgets as part of the basic financial statements.

217. Still other proposals would change the presentation of financial accounting information rather than its accumulation and processing. New financial statements and new forms of existing financial statements have been proposed. The use of ratios instead of money amounts has been suggested, pointing to an emphasis on information such as trends, relationships, rates of return, and statements expressed in terms of percentages, rather than on absolute dollar amounts. Development of ways of disclosing information more effectively than in narrative notes has been proposed, including more use of graphs, charts, and other visual aids.

218. Considerable interest has been shown in international accounting standards or "international generally accepted accounting principles." Prerequisite to the development of accounting standards on an international scale is not only knowledge of accounting practices and principles in various countries but also some attempts on the part of the accounting profession of each country to formalize and codify the accounting practices used in the country.

219. These proposals are mentioned in this Statement not to give them recognition or support but to indicate the general nature of potential changes in ideas and conditions in the future. Financial accounting promises to be as dynamic in the future as it has been in the past. The Accounting Principles Board will be involved in guiding future changes in generally accepted accounting principles. It invites all those interested in continued improvement in financial accounting to participate actively.

The Statement entitled "Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises" was adopted by the assenting votes of seventeen members of the Board. Mr. Catlett dissented.

George R. Catlett dissents to this Statement because in his view it fails to provide what purports to be "a basis for guiding the future development of financial accounting." He believes that guidelines for the future are urgently required, but the Accounting Principles Board is looking backward to what has occurred rather than forward to what is needed. As a result, the concepts and principles set forth in this Statement are based upon ineffective foundations, along the lines of the following: (1) vague generalizations which are noncontroversial but serve no useful purpose; (2) circular reasoning, with undefined terms being defined by other undefined terms, such as the description of assets and liabilities as those items "recognized and measured in conformity with generally accepted accounting principles;" and (3) reverse logic, by summarizing a wide variety of customs and practices, many of which need to be changed and improved, and then rationalizing back to principles that presumably support what now exists. The Board in this Statement is establishing a new acceptibility on behalf of the accounting profession for many accounting practices which have not previously been covered by pronouncements of the Board and which have not been studied or even seriously considered by the Board. Mr. Catlett also believes that this Statement—by providing a conceptual basis for, and by giving authoritative status to, current accounting practices—will represent an unfortunate deterrent to the achievement of improvements in practice. Thus, rather than setting forth effective guidelines for progress, this Statement creates a significant roadblock which will seriously impede the efforts of the business community and the accounting profession to establish sound principles for financial accounting and reporting.

NOTE

Statements of the Accounting Principles Board present the conclusions of at least two-thirds of the members of the Board, which is the senior technical body of the Institute authorized to issue pronouncements on accounting principles. This Statement is not an "Opinion of the Accounting Principles Board" covered by action of the Council of the Institute in the Special Bulletin, Disclosure of Departures from Opinions of Accounting Principles Board, *October 1964.*

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Prepared by the committee on terminology and published by authority of the committee on accounting procedure, American Institute of Accountants. The granting of such authority by that committee connotes its general agreement with opinions expressed herein as to the meaning of established terminology in accounting usage. As to any recommendation made herein for modifying established terminology, authority for publication indicates that the committee on accounting procedure regards such modification as a desirable objective not in conflict with generally accepted accounting principles.

Accounting Terminology Bulletin No. 1

REVIEW AND RÉSUMÉ

AUGUST, 1953

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FOREWORD

Between November, 1940, and October, 1949, the series of Accounting Research Bulletins issued by the committee on accounting procedure included eight (Nos. 7, 9, 12, 16, 20, 22, 34, and 39) which had been developed by the committee on terminology. Although approved generally by the committee on accounting procedure, they were not issued as its formal pronouncements, and have been omitted from the restatement of Accounting Research Bulletins Nos. 1 to 42, which has been published as Bulletin No. 43. The paragraphs which follow are almost wholly excerpts from these eight terminology bulletins; there has been no intentional change in the conclusions reached or in the substance of the views expressed in the committee's earlier utterances. The purpose is to initiate, with a review of what has gone before, a series of bulletins on terminology separate from those on accounting procedure. The committee believes that the field of terminology will afford stimulating subjects for future bulletins as the practice of the art of accounting is kept abreast of the times.

INTRODUCTION

1. The Committee on Terminology was constituted in 1920 and assigned the task of compiling a vocabulary of words and expressions used peculiarly in accounting and of gradually preparing definitions thereof. In 1931 definitions which had been formulated were brought together in a volume published by the Institute under the title *Accounting Terminology*, but without official approval and with emphasis on its tentative character. In the years that have since elapsed events have forced accountants to give more careful consideration to the use of words, as the responsibilities that may flow from careless or inaccurate usage have become more serious and manifest. Since 1939 the members of the committee on terminology have (with rare exceptions) been chosen from the membership of the committee on accounting procedure.

2. As a field of activity or thought extends, and a need for new modes of expression arises, the need may be met by the development of new words, or by expanding the meaning of words already in use. Either course has its dangers; in the one case that of not being understood, in the other that of being misunderstood. Where, as in the case of accounting, the need arises from the growth of an old activity, the second alternative is likely to be adopted more freely than the first and the resulting danger of being misunderstood is very real.

3. Illustrations may be noted from the uses in accounting of the words *value, assets,* and *liabilities.* A correct understanding of these uses is fundamental to the understanding of many other accounting terms.

4. The term *value* is used in accounting to signify some attribute of an asset (or other accounting factor); this attribute is expressed in terms of money, which may or may not reflect intrinsic worth, and is normally indicated by a qualifying adjective (e.g., *book value, replacement value,* etc.). Furthermore in accounting, *values* as thus broadly viewed, although not homogeneous, may be aggregated or deducted from one another. Thus, it is a universally accepted practice to add the cost value of one asset to the market value of another, and to deduct from the sum the amount of a liability to arrive at a net figure. This procedure, although open to obvious criticism of its mathematical propriety, possesses so many practical advantages and is so well established that it is not likely to be abandoned.

5. The words *assets* and *liabilities* are in accounting usage often no more than substitutes for *debits* and *credits* as headings for the two sides of a balance sheet. Not all the items carried under these headings are assets or liabilities in the ordinary sense of those words, nor are all the items that are assets or liabilities in the ordinary sense commonly included under these headings. Thus in one case unamortized discount on bonds (not an asset) may be found under the heading of assets, while in another case goodwill (possibly the most valuable of assets) may not be found at all.

6. The failure of accountants to emphasize and explain their conventional uses of these and other terms has given rise to criticism of accounting statements and of the profession. Students from other fields are apt to regard as revelations and as grounds for adverse criticisms what are really truisms accepted with respect to accounts not only by accountants but by business men and by regulatory bodies generally.

ACCOUNTING—ACCOUNTANCY

7. No words are employed more commonly than these, either in the practice or in the teaching of the subject; yet many differences arising in accounting writings have their roots in different conceptions of these basic terms. A careful consideration of these words will therefore add to understanding, not only among accountants themselves, but also among those outside the profession who have to do with accounting.

8. That publishers of general dictionaries had not, before the committee on terminology first expressed itself publicly, given adequate attention to the special uses of accounting terms was very evident from what the committee found with respect to their treatment of the words here under consideration. One dictionary consulted contained no definition of *accounting,* though it used the word in defining the verb *account* as "To furnish or receive an accounting." For the noun *accounting,* the more formal *accountancy* was made to serve, and was defined as "The work or art of an accountant." Turning therefore to *accountant,* hoping to find a definition which did not use the word to be defined, the committee found only that he is "one who keeps, examines, or is skilled in accounts; one whose business

is to keep or examine books of a mercantile or banking house or in a public office."

9. After extensive consultation and careful consideration, the committee in 1941 formulated the following definition:

> Accounting is the art of recording, classifying, and summarizing in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character, and interpreting the results thereof.

10. Public accounting is the practice of this art by one whose services are available to the public for compensation. It may consist in the performance of original work, in the examination and revision of the original work of others, or in the rendering of collateral services for which a knowledge of the art and experience in its practice create a special fitness.

11. If accounting were called a science, attention would be directed (and perhaps limited) to the ordered classifications used as the accountant's framework, and to the known body of facts which in a given case are fitted into this framework. These aspects of accounting cannot be ignored, but it is more important to emphasize the creative skill and ability with which the accountant applies his knowledge to a given problem. Dictionaries agree that in part art is science, and that art adds the skill and experience of the artist to science; it is in this sense that accounting is an art.

12. Except as in the two preceding paragraphs, the committee chose not to amplify the definition which it put forth. It rejected suggestions that the definition be made more explicit by mention of other details of accounting, because it questioned the desirability of writing its definition in terms which, while perhaps sharpening its presentation, might also unduly limit its scope. After the passage of more than ten years, this choice of broad but significant language continues to seem wise, and the definition to appear comprehensive as well as succinct.

13. From the establishment of the Interstate Commerce Commission and of other regulatory commissions, accounting has served these bodies and the railroads and other utilities under their jurisdiction in the solution of rate-fixing and related problems. Following the adoption of the income-tax amendment, it quickly became and has ever since remained apparent that in the implementation of that amendment accounting is a *sine qua non* for ascertaining the income to be taxed. The complexities of modern business have brought to management some problems which only accounting can solve, and others on which accounting throws necessary and helpful light. With the widening of corporate ownership, accounting was found both necessary to and capable of an intelligible presentation, within reasonable compass, of the financial data required to be furnished by management to investors. Although all of these facets of accounting, and many others, had long been well known to the business world, the committee included in its definition no specific mention of any of them; but careful attention to such phrases as "summarizing in a significant manner," "transactions and events . . . of a financial character," and "interpreting the results thereof," will reveal that the definition is in fact broad enough to cover them all.

14. Similar careful attention to the significant words, "the art of recording, classifying, and summarizing" will rule out any interpretation that no more is indicated than bookkeeping. The recording and classifying of data in account books constitute an accounting function, but so also and on a higher level do the summarizing and interpreting of such data in a significant manner, whether in reports to management, to stockholders, or to credit grantors, or in income tax returns, or in reports for renegotiation or other regulatory purposes.

ACCOUNTING PRINCIPLES

15. It is desirable that the accountant conceive of his work as a complex problem to be solved and of his statements as creative works of art, and that he reserve to himself the freedom to do his work with the canons of the art constantly in mind and as his skill, knowledge, and experience best enable him. Every art must work according to a body of applicable rules, but it also must reserve the right to depart from the rules whenever it can thereby achieve a better result.

16. Dictionaries agree in giving at least three orders of definitions of *principle*. The first is: "source, origin, or cause," which is of little help to accountants except as it emphasizes the primary character of some principles. The second is: "A fundamental truth or proposition on which many others depend; a primary truth comprehending or forming the basis of various subordinate truths." The third is: "A general law or rule adopted or professed as a guide to

action; a settled ground or basis of conduct or practice. . . ."

17. This third definition comes nearest to describing what most accountants, especially practising public accountants, mean by the word *principle*. Initially, accounting postulates are derived from experience and reason; after postulates so derived have proved useful, they become accepted as principles of accounting. When this acceptance is sufficiently widespread, they become a part of the "generally accepted accounting principles" which constitute for accountants the canons of their art. It is not convenient, either in conversation or in writing on accounting subjects, to add "(meaning number three)" each time the word *principle* is used, though that essentially is understood.

18. Care should be taken to make it clear that, as applied to accounting practice, the word *principle* does not connote a rule from which there can be no deviation. An accounting principle is not a principle in the sense that it admits of no conflict with other principles. In many cases the question is which of several partially relevant principles has determining applicability.

BALANCE SHEET—ASSETS—LIABILITIES

19. Since the committee's mid-year report in 1941, and consistently with what was said in that report, there has been marked progress toward greater logic and usefulness in what nevertheless still are referred to as balance-sheet presentations. It may be that at some future date the term *balance sheet* will cease to be used to designate a presentation of financial position and will instead be deemed to refer (as the term *trial balance* already refers) to a mere step, or point of arrival-and-departure, in preparing such a presentation. This possibility the committee leaves for future exploration.

20. The terms *balance sheet, assets* and *liabilities* are so closely related that the three can best be considered together. Indeed, the procedure is often adopted of first defining a balance sheet as a statement of assets and liabilities (or of assets, liabilities, and capital) and then undertaking the definition of assets and liabilities. This procedure, however, overlooks the fact that a balance sheet is historically a summary of balances prepared from books of account kept by double-entry methods, while a statement of assets and liabilities may be prepared for an organization for which no such books are kept; moreover such a summary may fall short of being an adequate statement of assets and liabilities. Since *balance sheet* is a distinctly technical accounting term while *assets* and *liabilities* are less so, the committee feels that *balance sheet* should be defined with reference to the origin (that is, the origin in the accounts) of its constitutent parts, and that the relation of assets and liabilities to the concept of the balance sheet should be considered subsequently.

21. In this view a balance sheet may be defined as:

> A tabular statement or summary of balances (debit and credit) carried forward after an actual or constructive closing of books of account kept according to principles of accounting.

22. For purposes of contrast, the definition in the *Century Dictionary* (taken from Bouvier's *Law Dictionary*, 1934) is worthy of analysis. It reads as follows:

> A statement made by merchants and others to show the true state of a particular business. A balance sheet should exhibit all the balances of debits and credits, also the value of the merchandise, and the result of the whole.

The use of the word *true* in the first sentence is regrettable since it adds nothing to the definition but suggests a possibility of certainty that does not exist. The second sentence recognizes the nature of the balance sheet as a statement of balances. From the reference to merchandise, one might infer that the definition originated in a day when the inventory was a figure introduced into the books only as a part of the final closing. The use here of the term *value* is characterized by the looseness noted in the discussion below (see paragraph 35) of the meanings of that term when used in accounting.

23. The committee once said that the term *balance sheet* had too often been construed in a mood of wishful thinking to describe what the writer would like a balance sheet to be; perhaps the definition just cited reflected such a mood. With the passing of time and with the greater development and more widespread understanding of accounting principles, the committee now feels that commercial and industrial usage has tended toward the reconciling of these two definitions so that in those fields a

balance sheet as contemplated in the first may indeed be the statement of assets and liabilities which appears to be contemplated in the second.

24. Accounting analysis frequently requires that two accounts be carried, with balances on opposite sides, in respect to the same thing (e.g., a building account, and a building-depreciation account). In the balance sheet, however, the net amount of such balances is usually though not invariably shown.

25. Those things which are reflected in the net debit balances that are or would be properly carried forward are termed *assets,* and those reflected in net credit balances, *liabilities.* Hence the expression *statement of assets and liabilities* is frequently used as synonymous with *balance sheet,* though as already pointed out not every statement of assets and liabilities is a balance sheet.

26. The word *asset* is not synonymous with or limited to property but includes also that part of any cost or expense incurred which is properly carried forward upon a closing of books at a given date. Consistently with the definition of *balance sheet* previously suggested, the term *asset,* as used in balance sheets, may be defined as follows:

> Something represented by a debit balance that is or would be properly carried forward upon a closing of books of account according to the rules or principles of accounting (provided such debit balance is not in effect a negative balance applicable to a liability), on the basis that it represents either a property right or value acquired, or an expenditure made which has created a property right or is properly applicable to the future. Thus, plant, accounts receivable, inventory, and a deferred charge are all assets in balance-sheet classification.

The last named is not an asset in the popular sense, but if it may be carried forward as a proper charge against future income, then in an accounting sense, and particularly in a balance-sheet classification, it is an asset.

27. Similarly, in relation to a balance sheet, *liability* may be defined as follows:

> Something represented by a credit balance that is or would be properly carried forward upon a closing of books of account according to the rules or principles of accounting, provided such credit balance is not in effect a negative balance applicable to an asset. Thus the word is used broadly to comprise not only items which constitute liabilities in the popular sense of debts or obligations (including provision for those that are unascertained), but also credit balances to be accounted for which do not involve the debtor and creditor relation. For example, capital stock and related or similar elements of proprietorship are balance-sheet liabilities in that they represent balances to be accounted for, though these are not liabilities in the ordinary sense of debts owed to legal creditors.

Consideration of the facts noted in the last sentence of this definition has led some accountants to the view that the aggregate of *liabilities* as contemplated in this definition should be referred to as the aggregate of *liabilities and capital,* and that the balance sheet consists of an asset section, a liability section, and a proprietary or capital section, with the monetary amounts represented by the first shown as equal to the sum of those represented by the other two. The committee feels that there is no inconsistency between this view and the suggested definition.

INCOME—INCOME STATEMENT PROFIT—PROFIT AND LOSS STATEMENT UNDISTRIBUTED PROFITS—EARNED SURPLUS

28. Although the term *income account* continues to be used somewhat to designate a financial statement prepared from accounts and designed to show the several elements entering into the computation of net income for a given period, the more modern practice is to use instead the term *income statement;* one of the effects of this practice is to restrict the use of the term *account* to the technical running record in the ledger, from the aggregate of which the financial statements are prepared.

29. The terms *profit* and *profit and loss account* (or *profit and loss statement*) are older, and perhaps more inclusive and more informative, expressions to be applied to industrial and mercantile enterprises and

their results than are the terms *income* and *income account* (or *income statement*). The term *profit and loss* seems to have been in use before Paciolo's work was published in 1494, and what was perhaps the earliest bookkeeping text in England (*A Briefe Instruction*, by John Mellis, published in 1588) contained a chapter treating "Of the famous accompt called profite and losse, or otherwise Lucrum and Damnum, and how to order it in the Leager." This is the earliest work cited by *A New English Dictionary on Historical Principles*, 1888-1928, as having used the phrase *profit and loss*, which the dictionary defines as "an inclusive expression for the gain and loss made in a series of commercial transactions"; it also defines *profit and loss account* as "an account in book-keeping to which all gains are credited and losses are debited, so as to strike a balance between them, and ascertain the net gain or loss at any time." The same dictionary shows 1601 as the issue-date of the earliest work discussing *income*, which term it defines as meaning the periodical produce of one's work, business, lands, or investments; it seems significant that the dictionary does not define or otherwise mention the *income account*.

30. Clearly, an opportunity existed for distinctive uses of the terms *earnings*, *income*, and *profits*, and of the corresponding *accounts* or *statements*. Not too long ago, usage applied *earnings* to concerns rendering services, *profits* to manufacturing and mercantile concerns, and *income* to the compensation or revenue received by an individual. In recent years, there has been an increasing tendency to substitute the term *income statement* for the term *profit and loss statement*, and to regard these two terms as equally inclusive.

31. It is important that accountants keep in the forefront of any discussion of *income*, its composite nature as the resultant of positive (credit) and negative (debit) elements. The income statement can be informative only as it discloses such of these positive and negative elements as are significant.

32. The cumulative balance of *profit and loss* (or *income*) after deductions of dividends was long called *undivided profits*, but later came to be more commonly called *earned surplus*. The change brought no increase of accuracy or lucidity but rather the reverse. It is difficult to see why the word *surplus* was used at all, and the introduction of the challenging and often unwarranted word *earned* seems to be wholly regrettable. In 1949, this committee secured the approval of the committee on accounting procedure for its recommendation that the use of the term *surplus* in balance-sheet presentations be discontinued (see page 28).

33. As early as 1924 the Institute appointed a special committee whose task was merely to define *earned surplus*; it was not directed to consider alternatives. That special committee, after an extensive inquiry, in 1930 submitted to the Council of the Institute a report suggesting a definition which the Council duly received but on which it took no action.

34. By that definition only slightly modified, the term *earned surplus* (or *undistributed profits* or *retained income*) means:

> The balance of net profits, income, gains and losses of a corporation[1] from the date of incorporation (or from the latest date when a deficit was eliminated in a quasi-reorganization) after deducting distributions therefrom to shareholders and transfers therefrom to capital stock or capital surplus accounts.

VALUE AND ITS DERIVATIVES

35. *Value* is a word of many meanings. Just as beauty is said to lie in the eye of the beholder, so worth may lie in the mind of the appraiser. There is often no unique standard of worth which is both realistic and objectively applicable. The fact that there are different criteria of worth is strikingly illustrated in Supreme Court decisions which have applied different methods of determining value in connection with the regulation, taxation, and reorganization, respectively, of railroads. But apart from the difficulty of measuring *value* when the word is used to connote *worth*, it is evident that in the literature of business, economics, and accounting, *value* is used in varying significances, not all of which have any definite connotation of worth. The word is commonly employed in accounting to describe the figure at which an asset or liability is carried in the accounts, even though the amount may be determined by a process

[1] Other than gains from transactions in its own shares, and losses therefrom chargeable to capital surplus; see chapter 1(b) of Accounting Research Bulletin No. 43, paragraphs 7 and 8.

which is not one of valuation in any ordinary sense.

36. Since accounting is predominantly based on cost, the proper uses of the word *value* in accounting are largely restricted to the statement of items at cost, or at modifications of cost. In accounting, the term *market value* is used in senses differing somewhat from those attaching to the expression in law. As applied to securities, it means a sum computed on the assumption that value is measurable by market quotations; as applied to inventories, it is compiled from a variety of considerations, including market quotations, cost of replacement, and probable sales price. In the case of so-called fixed assets the *value* shown in accounts is the balance of their cost (actual or modified) after deducting recorded depreciation. Thus the following definition would seem to be appropriate:

> *Value* as used in accounts signifies the amount at which an item is stated, in accordance with the accounting principles related to that item. Using the word *value* in this sense, it may be said that balance-sheet values generally represent cost to the accounting unit or some modification thereof; but sometimes they are determined in other ways, as for instance on the basis of market values or cost of replacement, in which cases the basis should be indicated in financial statements.

37. The word *value* should seldom if ever be used in accounting statements without a qualifying adjective.

AUDIT AND ITS DERIVATIVES

38. The origin of the word *audit* relates it to *hearing*, and traces of this early usage, signifying the hearing by proper authorities of accounts rendered by word of mouth, still linger in such phrases as *hearing witnesses* and *examine witnesses* included in some dictionary definitions of *audit*. From this to the modern applications of the word is, however, a considerable distance.

39. The use of the term *audit* has been extended to include the examination of any records to ascertain whether they correctly record the facts purported to be recorded. The next step extended the usage to statements prepared as summaries of records, so that an audit was concerned not only with the truth of the records, but also with the question whether or not the statements were faithfully prepared from those records.

40. But the most notable development in the use of the term is that which has to do with the preparation of statements "in conformity with generally accepted accounting principles," signifying that the auditor's concern is not restricted to the technical accuracy of the records, but goes also to the principles which have governed the accounting allocations entering into the results shown in the statements.

41. It thus becomes clear that the end result of the audit is in many cases the expression of an opinion by the auditor to the effect that the statements are what they purport to be. But such general terms as that could not satisfy the requirements of the situation, since they would leave it open to the reader to supply his own standards or definitions of what the statements are intended to mean. Hence the reference, in the standard short form of accountant's report recommended by the Institute's committee on auditing procedure, to "conformity with generally accepted accounting principles." Only in the light of these principles is it proper to interpret and judge the statement.

42. The word *opinion* is also important. In the circumstances described it is not possible for the auditor to state as a literal fact that the statements are true, or that they have been prepared "in conformity with generally accepted accounting principles." All that the circumstances warrant is an expression of opinion; and although it is true that the auditor is expected to have qualified himself to express an opinion, both by his general training and by his examination in the particular case, yet his audit properly results in a statement of opinion, not of fact.

43. These considerations suggest definitions of *audit* as follows:

> In general, an examination of an accounting document and of supporting evidence for the purpose of reaching an informed opinion concerning its propriety. Specifically:
>
> (1) An examination of a claim for payment or credit and of supporting evidence for the purpose of determining whether the expenditure is properly authorized, has been or should be duly made, and how it

should be treated in the accounts of the payor—hence, *audited voucher.*

(2) An examination of similar character and purpose of an account purporting to deal with actual transactions only, such as receipts and payments.

(3) By extension, an examination of accounts which purport to reflect not only actual transactions but valuations, estimates, and opinions, for the purpose of determining whether the accounts are properly stated and fairly reflect the matters with which they purport to deal.

(4) An examination intended to serve as a basis for an expression of opinion regarding the fairness, consistency, and conformity with accepted accounting principles, of statements prepared by a corporation or other entity for submission to the public or to other interested parties.

AUDITOR'S REPORT (OR CERTIFICATE)

44. The Securities Act of 1933 repeatedly speaks of statements "certified" by accountants, and this usage was followed in the regulations of the Securities and Exchange Commission. Before 1933, however, question had been raised as to the propriety and usefulness in this connection of the words to *certify* and *certificate;* it was pointed out that they were misleading to the extent that they conveyed to ordinary readers an impression of greater certainty or accuracy than the statements could possess, or that they represented that the auditor was expressing more than his opinion about the statements. In a letter dated December 21, 1933, the Institute's special committee on cooperation with stock exchanges wrote: "To this end, we think it desirable that the document signed by the accountants should be in the form of a report, as in England, rather than a certificate, and that the words 'in our (my) opinion' should always be embodied therein." But one of the notes to the form recommended with that letter spoke of the "certificate," and other committees have frequently found themselves obliged to use *report* and *certificate* interchangeably. In these circumstances the continued use of both terms can scarcely be avoided, and the important thing is to emphasize the fact that the choice of one term or the other implies no difference of scope or purport, and to make that purport clear. This might be done by the following definition:

> The report (or certificate) of an independent accountant (or auditor) is a document in which he indicates the nature and scope of the examination (or audit) which he has made and expresses the opinion which he has formed in respect of the financial statements.

45. The word *report* as synonymous with *certificate* (sometimes also called "short form of report") is used primarily in connection with audits of the kind covered by the fourth of the specific definitions suggested above. In relation to other kinds of audits the report may take varying forms according to the nature and scope of the work undertaken.

DEPRECIATION

46. The word *depreciation* is an outstanding example of a term used in accounting in specialized senses. The sense in which accountants use this term differs not only from its colloquial sense but also from the sense in which it is used in engineering; and it is far removed from the root-meaning (diminution in price or value) of the word itself. The committee therefore feels that there rests on the profession an obligation to clarify the meaning of the word when used as a term of art in accounting. This is the more desirable since the accounting concept of the term has in recent years won increasing acceptance from courts and regulatory commissions.

Definitions from Other Sources

47. Before formulating its own definition in 1944, the committee considered a number of earlier definitions from other sources, some of which are quoted below:

(1) Webster's *New International Dictionary* (1934):

(a) "Depreciation: (Accounting). Decline in value of an asset due to such causes as wear and tear, action of the elements, obsolescence, and inadequacy."

(b) "Depreciation charge: (Accounting). An annual charge to cover depreciation and obsolescence, usually in the form of a percentage, fixed in advance, of the cost of the property depreciated."

(2) United States Supreme Court, in *Lindheimer v. Illinois Bell Telephone Company*, 292 U. S. 151 (1934):

"Broadly speaking, depreciation is the loss, not restored by current maintenance, which is due to all the factors causing the ultimate retirement of the property. These factors embrace wear and tear, decay, inadequacy and obsolescence. Annual depreciation is the loss which takes place in a year."

(3) National Association of Railroad and Utilities Commissioners, *Report of Special Committee on Depreciation*, "Depreciation Principles and Methods" (1938), pp. 8-10:

". . . depreciation, as applied to depreciable utility plant, means the loss in service value[1] not restored by current maintenance, incurred in connection with the consumption or prospective retirement of utility plant in the course of service from causes which are known to be in current operation and against which the utility is not protected by insurance. Among the causes to be given consideration are wear and tear, decay, action of the elements, inadequacy, obsolescence, changes in the art, changes in demand and requirements of public authorities, and, in some cases, the exhaustion of natural resources."

(4) United States Treasury Department, Bureau of Internal Revenue, *Regulations 103 relating to the Income Tax* (1940):

"Sec. 19.23(1)—1. Depreciation: A reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in the trade or business may be deducted from gross income. For convenience such an allowance will usually be referred to as depreciation, excluding from the term any idea of a mere reduction in market value not resulting from exhaustion, wear and tear, or obsolescence. The proper allowance for such depreciation of any property used in the trade or business is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate) whereby the aggregate of the amounts so set aside, plus the salvage value, will, at the end of the useful life of the property in the business, equal the cost or other basis of the property determined in accordance with section 113. Due regard must also be given to expenditures for current upkeep."

NOTE. The foregoing language is substantially identical with that on the same subject in Regulations 62 (1922), Regulations 65 (1924), Regulations 74 (1928), Regulations 77 (1933), Regulations 86 (1935), Regulations 94 (1936), Regulations 101 (1939), and Regulations 111 (1943 et subs.).

(5) Montgomery, *Auditing Theory and Practice:*

(a) *First Edition* (1912), page 317:

"Entirely extraneous influences may cause fluctuation in the value of assets. . . . Depreciation, however, is a decline in the value of property such as may reasonably be expected to occur as a result of wear and tear and gradual obsolescence. It is due to the possession and use of the assets, and therefore is a part of the cost of operation."

(b) *Sixth Edition* (1940), page 477:

"To accountants fixed assets represent an investment in physical property, the cost of which, less salvage, must be charged to operations over the period of the useful life of such property. Hence, fixed assets are really in the nature of special deferred charges of relatively long service life, the absorption of which is called by the distinctive name 'depreciation.'"

[1] Elsewhere in the same report, *service value* is defined as "the difference between the original cost and the net salvage value of utility plants. . . ."

(6) Paton, *Essentials of Accounting* (1938), page 530:

> "'Depreciation' has come to be used particularly to designate the expiration of the cost or value of buildings and equipment in the course of business operation . . ."

48. These definitions view depreciation, broadly speaking, as describing not downward changes of value regardless of their causes but a money cost incident to exhaustion of usefulness. The term is sometimes applied to the exhaustion itself, but the committee considers it desirable to emphasize the cost concept as the primary if not the sole accounting meaning of the term: thus, *depreciation* means the cost of such exhaustion, as *wages* means the cost of labor.

49. It is recognized by some if not all of these definitions that the whole cost of exhaustion of usefulness is not included within the accounting concept of *depreciation*, but there is not complete unanimity as to what should be excluded. Exhaustion is constantly being both retarded and in part restored by current maintenance and, in defining *depreciation*, costs chargeable to maintenance must be excluded from the cost incident to exhaustion. Immediately, a question arises as to whether the exclusion should be (a) the cost of exhaustion which is in fact restored by current maintenance or (b) the cost of exhaustion which would be restored by adherence to an established standard of maintenance. The above-quoted definitions by the Court (2) and the Commissioners (3) accept the former alternative and that by the Treasury (4), while not explicit, appears similar in intent. However, depreciation accounting is normally based on assumed standards of maintenance, and depreciation charges are not as a rule varied as maintenance cost rises or falls. It is probably correct to say that if in a single and exceptional period maintenance cost is either materially above or materially below the assumed standards, the excess or deficiency should be treated as outside the scope of depreciation, but that a change in maintenance policy or in a classification of maintenance charges would call for a reconsideration of the system of depreciation accounting.

50. Exhaustion of usefulness may result from causes of materially different character, some physical, others functional and others possibly financial, some operating gradually, others suddenly. The Supreme Court's definition (2) of depreciation includes the words "all the factors causing the ultimate retirement of the property," but it also gives a list of such factors and those mentioned are all gradual in operation. The Treasury's definition (4) likewise gives a list of factors which is similarly restricted. The definition by the Commissioners (3) is in terms more comprehensive but introduces a new exception: it includes "causes which are known to be in current operation and against which the utility is not protected by insurance." Certain of the causes specifically enumerated in these three definitions—wear and tear, decay (exhaustion), inadequacy, and obsolescence—are included in all three; the Court and the Treasury recognize no other causes, but the Commissioners add "action of the elements," "changes in the art," "changes in demand," and "requirements of public authorities."

51. "Action of the elements" may be either gradual or sudden, and including as *depreciation* losses due to storms, fires, and floods if not covered by insurance, seems clearly to extend the concept of depreciation from one of a long-term deferred charge (see definition 5) to something more in the nature of self-insurance. Such an extension might be justifiable if application of the term is restricted to large groups of properties collectively as against relatively small separate units, because as to a large group the losses from such causes over a period of years may be reasonably foreseeable, while in the case of single units they are not. However, application of the term *depreciation* to losses due to sudden and violent action of the elements may be questioned, especially by those who oppose attempts to smooth out reported profits artificially. "Changes in the art" may be regarded as one cause of obsolescence, and the inclusion of these words in the definition as a redundancy. "Changes in demand" is more inclusive than "inadequacy"; it would presumably cover the losses due to superfluity of capacity, which in some circumstances may become of even greater importance than inadequacy. "Requirements of public authorities" may perhaps be regarded as an inclusion deemed particularly applicable to utilities and not necessarily relevant to unregulated enterprises.

52. In industrial accounting, the meaning of *depreciation* conforms more closely to the definitions of the Court and the

Treasury than to that of the Commissioners; in this field depreciation provisions are generally limited to costs or losses which are not restorable by current maintenance and are (a) gradual in their nature, (b) due to physical or functional causes, and (c) reasonably foreseeable.

Committee Definition

53. The committee regards it as a good procedure first to define *depreciation accounting*, and then to describe the various senses in which the words *depreciate* and *depreciation* are used in connection with such accounting.

54. Depreciation accounting is clearly a special technique (like cost accounting or accrual accounting). It can be sharply distinguished from the replacement system, the retirement system, the retirement reserve system, and the appraisal system, all of which have at times been employed in dealing with the same subject matter in accounting. Depreciation accounting may take one of a number of different forms. The term is broadly descriptive of a type of process, not of an individual process, and only the characteristics which are common to all processes of the type can properly be reflected in a definition thereof. These common characteristics are that a cost or other basic value is allocated to accounting periods by a rational and systematic method and that this method does not attempt to determine the sum allocated to an accounting period solely by relation to occurrences within that period which affect either the length of life or the monetary value of the property. Definitions are unacceptable which imply that *depreciation for the year* is a measurement, expressed in monetary terms, of the physical deterioration within the year, or of the decline in monetary value within the year, or, indeed, of anything that actually occurs within the year. True, an occurrence within the year may justify or require a revision of prior estimates as to the length of useful life, but the annual charge remains an allocation to the year of a proportionate part of a total cost or loss estimated with reference to a longer period.

55. Obviously, the term *depreciation* as here contemplated has a meaning different from that given it in the engineering field. The broad distinction between the senses in which the word is used in the two professions is that the accounting concept is one of systematic amortization of cost (or other appropriate basis) over the period of useful life, while the engineering approach is one of evaluating present usefulness.

56. After long consideration the committee on terminology formulated the following definition and comments:

> *Depreciation accounting* is a system of accounting which aims to distribute the cost or other basic value of tangible capital assets, less salvage (if any), over the estimated useful life of the unit (which may be a group of assets) in a systematic and rational manner. It is a process of allocation, not of valuation. *Depreciation for the year* is the portion of the total charge under such a system that is allocated to the year. Although the allocation may properly take into account occurrences during the year, it is not intended to be a measurement of the effect of all such occurrences.

NOTE: This method of accounting may be contrasted with such systems as the replacement, the retirement, the retirement reserve, and the appraisal methods of recognizing the fact that the life of certain fixed assets is limited.

The words *depreciate* and *depreciation* are used in various ways in connection with depreciation accounting. The verb is used in a transitive as well as in an intransitive sense (cf., the use of accrue in accrual accounting). The noun is used to describe not only the process but also a charge resulting from the process or the accumulated balance of such charges; it is also used to describe the exhaustion of life which gives rise to the method of accounting.

In all these uses, the meaning of the word is sharply distinguished from the sense of "fall in value" in which the word is employed in common usage and in respect to some assets (e.g., marketable securities) in accounting.

USE OF THE TERM "RESERVE"

57. The committee observed some years ago that the term *reserve* was being used in accounting in a variety of different and somewhat conflicting senses. As a result clarity of thought and accuracy of expression were impaired and an adequate under-

standing of financial statements on the part of users was made more difficult than necessary. In addition the variations in balance-sheet classification and presentation of the so-called reserves contributed to the confusion and made comparisons difficult.

58. The dictionaries define the term generally as something held or retained for a purpose, frequently for emergencies. In dealing with financial matters the term is commonly used to describe specific assets which are held or retained for a specific purpose. This is the sense in which the term is employed, for instance, in our banking system, which derives its name from the fact that member banks are required to maintain deposits with the central or *reserve* banks. The term is also used to indicate such assets as oil and gas properties which are held for future development. In accounting, such assets are described according to their nature or referred to as *funds* or *deposits* for specific purposes, generally without using the term *reserve*.

59. In accounting practice the term has been used in at least four senses, namely:

(1) To describe a deduction which is made (a) from the face amount of an asset in order to arrive at the amount expected to be realized, as in the case of a reserve for uncollectible accounts, or (b) from the cost or other basic value of an asset, representing the portion of the cost which has been amortized or allocated to income, in order to arrive at the amount properly chargeable to future operations, as in the case of a reserve for depreciation. In this sense the term has been said to refer to valuation reserves, reflected in the asset section of the balance sheet.

(2) To indicate an estimate of (a) an admitted liability of uncertain amount, as in the case of a reserve for damages, (b) the probable amount of a disputed claim, as in the case of a reserve for additional taxes, or (c) a liability or loss which is not certain to occur but is so likely to do so as to require recognition, as in the case of a reserve for self-insurance. These reserves have been included in the *liability* section of the balance sheet, or in a section immediately below the ordinary liabilities, or in the *proprietary* section. In the insurance field the term is used in this sense as referring to the portion of the total assets derived from premiums which is expected to be required to meet future payments under policies.

(3) To indicate that an undivided or unidentified portion of the net assets, in a stated amount, is being held or retained for a special purpose, as in the case of a reserve (a) for betterments or plant extensions, or (b) for excess cost of replacement of property, or (c) for possible future inventory losses, or (d) for general contingencies. In this sense a reserve is frequently referred to as an appropriation of retained income.

(4) In the income statement, to indicate a variety of charges, including losses estimated as likely to be sustained because of uncollectible accounts, depreciation, depletion, amortization, and general or specific contingencies. It is to be noted here that the term refers to the charge by means of which a reserve (in any of the three preceding senses) is created.

60. The committee in 1948 recommended that in accounting practice the use of the term *reserve* be limited to the third of the four senses set forth above, i.e., to indicate that an undivided portion of the assets is being held or retained for general or specific purposes, and that the use of the term in the income statement or to describe in the balance sheet deductions from assets or provisions for particular liabilities should be avoided. There appears to be increasing recognition of the soundness of this recommendation.

61. The first and second accounting usages of the term set forth above seem not only clearly contrary to its commonly accepted meaning but also lacking in technical justification. As to the first, a so-called reserve for bad debts or for depreciation does not in itself involve a retention or holding of assets, identified or otherwise, for any purpose. Its function is rather a part of a process of measurement, to indicate a diminution or decrease in an asset due to a specified cause. Nor is the suggested substitution of the term *provision* acceptable as an improvement, because any provision must of necessity and in the final analysis be made by the allocation or segregation of assets. The term *less reserve* in this area has been increasingly replaced by terms which indicate the measurement process, such as *less estimated losses in collection, less accrued depreciation,* etc.

62. As to the second of these four usages, it may be argued that the showing of any liability in the balance sheet is an indication that a portion of the assets will be required for its discharge, and that in this sense the showing may be regarded as a provision or reserve; however, it is clearly preferable to regard the showing as indicating the obligation itself, which is a deduction necessary to arrive at proprietary investment or net assets. The items in this area which have been described as reserves are therefore better designated in some such way as *estimated liabilities* or *liabilities of estimated amount.*

63. The use of the term *reserve* to describe charges in the income statement involves different considerations. It may be said that a charge of this nature, e.g. a charge for depreciation, indicates that cash or some other thing received by way of revenue has, to the extent indicated, been reserved or set aside for a special purpose, and therefore represents a reserve. However, the basic purpose in the making of these charges is one of income measurement, and the designation of such charges as costs, expenses, or losses, i.e. negative elements in determining income, is more understandable than their designation as *reserves.*

64. The generally accepted meaning of the term reserve corresponds fairly closely to the accounting usage which indicates an amount of unidentified or unsegregated assets held or retained for a specific purpose. This is the use to which the committee feels it should be restricted, and it is interesting to note that in the 1947 revision of the British Companies Act the use of the term was limited to this area.

USE OF THE TERM "SURPLUS"

65. In 1941 the committee suggested a general discontinuance of the use of the term *surplus* in corporate accounting, and a substitution therefor in the proprietorship section of the balance sheet of designations which would emphasize the distinction between (a) legal capital, (b) capital in excess of legal capital, and (c) undivided profits. Extensive discussions of the proposal followed, and in 1949 it was approved "as an objective" by the committee on accounting procedure.

66. A factor of primary importance in the balance-sheet presentation of the stockholders' equity is the status of ownership at the balance-sheet date. Where two or more classes of stockholders are involved, the interests of each must be presented as clearly as possible. These interests include the entire proprietary capital of the enterprise, frequently divided further, largely on the basis of source, as follows:

(1) Capital stock, representing the par or stated value of the shares.

(2) Capital surplus, representing (a) capital contributed for shares in excess of their par or stated value[3] or (b) capital contributed other than for shares.

(3) Earned surplus, representing accumulated income or the remainder thereof at the balance-sheet date.

67. While the terms *capital surplus* and *earned surplus* have been widely used, they are open to serious objection.

(1) The term *surplus* has a connotation of excess, overplus, residue, or "that which remains when use or need is satisfied" (Webster), whereas no such meaning is intended where the term is used in accounting.

(2) The terms *capital* and *surplus* have established meanings in other fields, such as economics and law, which are not in accordance with the concepts the accountant seeks to express in using those terms.

(3) The use of the term *capital surplus* (or, as it is sometimes called, *paid-in surplus*) gives rise to confusion. If the word *surplus* is intended to indicate capital accumulated by the retention of earnings, i.e. retained income, it is not properly used in the term *capital surplus;* and if it is intended to indicate a portion of the capital, there is an element of redundancy in the term *capital surplus.*

(4) If the term *capital stock* (and in some states the term *capital surplus*) be used to indicate capital which, in the legal sense, is restricted as to withdrawal, there is an implication in the terms *surplus* or *earned surplus* of availability

[3] This classification includes such items as capital transferred from capital stock account as a result of the reduction of par or stated value, and credits resulting from transactions in the corporation's own stock.

for dividends. This is unfortunate because the status of corporate assets may well be such that they are not, as a practical matter, or as a matter of prudent management, available for dividends.

68. In seeking terms more nearly connotative of the ideas sought to be expressed, consideration should be given primarily to the *sources* from which the proprietary capital was derived. In addition, regard should be had for certain types of events which may have occurred in the history of the corporation. Thus, a quasi-reorganization in which a "new start" has been made may be said to have put the entire net assets, as restated at the time, into the status of contributed capital, so that in subsequent balance-sheet presentations that part of proprietary capital sometimes described as *earned surplus* would include only income retained after the quasi-reorganization and would be "dated" accordingly. Likewise a stock dividend, or a transfer by resolution of the board of directors, must for purposes of subsequent balance-sheet presentation be dealt with as a transfer of capital accumulated by retention of income to the category of restricted capital. Finally, the classification of proprietary capital involves a consideration of present status in such matters as contractual commitments, dividend restrictions and appropriations of various kinds.

69. In view of the foregoing the committee in 1949 particularized the proposal which had been so long under consideration by recommending that, in the balance-sheet presentation of stockholders' equity:

(1) The use of the term *surplus* (whether standing alone or in such combinations as *capital surplus, paid-in surplus, earned surplus, appraisal surplus,* etc.) be discontinued.

(2) The contributed portion of proprietary capital be shown as:

(a) Capital contributed for, or assigned to, shares, to the extent of the par or stated value of each class of shares presently outstanding.

(b) (i) Capital contributed for, or assigned to, shares in excess of such par or stated value (whether as a result of original issue of shares at amounts in excess of their then par or stated value, or of a reduction in par or stated value of shares after issuance, or of transactions by the corporation in its own shares); and

(ii) Capital received other than for shares whether from shareholders or from others.

(3) The term *earned surplus* be replaced by terms which will indicate source, such as *retained income, retained earnings, accumulated earnings,* or *earnings retained for use in the business.* In the case of a deficit, the amount should be shown as a deduction from contributed capital with appropriate description.

(4) In connection with 2(b) and 3 there should, so far as practicable, be an indication of the extent to which the amounts have been appropriated or are restricted as to withdrawal. Retained income appropriated to some specific purpose nevertheless remains part of retained income, and any so-called "reserves" which are clearly appropriations or segregations of retained income, such as those for general contingencies, possible future inventory losses, sinking fund, etc., should be included as part of the stockholders' equity.

(5) Where there has been a quasi-reorganization, retained income should be "dated" for a reasonable time thereafter; and where the amount of retained income has been reduced as a result of a stock dividend or a transfer by resolution of the board of directors from unrestricted to restricted capital, the presentation should, until the fact loses significance, indicate that the amount shown as retained income is the remainder after such transfers.

(6) Any appreciation included in the stockholders' equity other than as a result of a quasi-reorganization should be designated by such terms as *excess of appraised or fair value of fixed assets over cost* or *appreciation of fixed assets.*

70. As already noted, this proposal was approved "as an objective" by the committee on accounting procedure although it has subsequently used the term *surplus* in certain of its pronouncements where it felt that the avoidance of such usage might seem to border on pedantry. The cogency of the reasons adduced for discontinuing the use of the term in balance-sheet pres-

entations of the stockholders' equity seems obvious, and that the proposal is winning general acceptance appears from analyses made by the Institute's research department of numerous published corporate financial statements: the proportion of such statements in which the term *surplus* was not used was 10 per cent for 1947 and 18 per cent for 1948, but for 1949, 1950, and 1951, after the recommendation was published, it was 32 per cent, 41 per cent, and 44 per cent, respectively.

Committee on Terminology (1952-53)

FREDERICK B. ANDREWS, *Chairman*
JOHN W. QUEENAN
C. AUBREY SMITH

Accounting Terminology Bulletin No. 2

PROCEEDS, REVENUE, INCOME, PROFIT, AND EARNINGS

MARCH, 1955

INTRODUCTION

1. The terms *revenue, income, profit,* and *earnings* refer to closely related concepts. In general, they relate to the increase (or decrease if negative) in the owners' equity which results from operations of an enterprise. They are, therefore, to be distinguished from receipts such as collection of receivables, and from proceeds of a loan or bond issue, or the capital contributions by owners.

2. The committee has examined the usage of these terms in accounting, economic, and legal literature and believes that the lack of uniformity found in practice is unfortunate and confusing. To promote uniformity of usage, the following definitions and recommendations are made for the use of these terms in connection with business operations and financial statements. The term *proceeds* also is included in the list of terms considered.

DEFINITIONS AND RECOMMENDATIONS

Proceeds

3. Definition:

> *Proceeds* is a very general term used to designate the total amount realized or received in any transaction, whether it be a sale, an issue of stock, the collection of receivables, or the borrowing of money.

4. Recommendation:

> This term is not ordinarily used as a caption in the principal financial statements and generally should be used only in discussions of transactions.

Revenue

5. Definition:

> *Revenue* results from the sale of goods and the rendering of services and is measured by the charge made to customers, clients, or tenants for goods and services furnished to them. It also includes gains from the sale or exchange of assets (other than stock in trade), interest and dividends earned on investments, and other increases in the owners' equity except those arising from capital contributions and capital adjustments.

6. Revenue, like proceeds, is a gross concept but revenue, unlike proceeds, does not include items such as amounts received from loans, owners' investments, and collection of receivables. In the case of ordinary sales, revenue is generally stated after deducting returns, allowances, discounts, freight, and other similar items; and in the case of sales of assets other than stock in trade, it is generally stated after deducting the cost of the assets sold. The revenue for a period less the cost of goods sold, other expenses, and losses will give the net results of business operations for the period. Revenue from ordinary sales or from other transactions in the ordinary course of business is sometimes described as operating revenue.

7. Recommendation:

> It is recommended that this meaning of the term revenue be adopted and that the term be more widely used in the preparation of financial statements and for other accounting purposes.

Income and Profit

8. Definition:

> *Income* and *profit* involve net or partially net concepts and refer to amounts resulting from the deduction from revenues, or from operating revenues, of cost of goods sold, other expenses, and losses, or some of them. The terms are often used interchangeably and are generally preceded by an appropriate qualifying adjective or term such as

"gross," "operating," "net . . . before income taxes," and "net." The terms are also used in titles of statements showing results of operations, such as "income statement" or "statement of profit and loss," or, sometimes, "profit and loss account."

9. The term *gross income* is often used as the equivalent of revenue; in public utility practice it is commonly used in referring to net income before deducting interest and other income charges. The term *gross profit* is frequently used to describe operating revenue less the cost of goods sold. The terms *operating income* or *operating profit* are generally used to denote "gross profit" less ordinary expenses. The terms *net income* or *net profit* refer to the results of operations after deducting from revenues all related costs and expenses and all other charges and losses assigned to the period. These deductions do not include dividends or comparable withdrawals.

10. Recommendation:

The committee recommends that when the terms are used in financial statements, they be preceded by the appropriate qualifying adjective. When referring to items covered by the term "revenue," the term "gross income" should be avoided. The excess of operating revenue over the cost of goods sold may be described as "gross profit" but such terms as "gross profit on sales" or "gross margin" are preferable. It also is recommended that the terms "operating income," "net income," and "income statement" be used instead of the related terms, "operating profit," "net profit" and "statement of profit and loss." It is, however, proper to use the term "profit" in describing a specific item such as "profit on sale of fixed assets."

Earnings

11. Definition:

The term *earnings* is not used uniformly but it is generally employed as a synonym for "net income," particularly over a period of years. In the singular the term is often combined with another word in the expression "earning power," referring to the demonstrated ability of an enterprise to earn net income.

12. Recommendation:

The committee is hopeful that eventually there will be a single term, uniformly used, to designate the net results of business operations. In recent years there has been a trend toward the term "earnings," although a majority of published financial statements employ the term "net income." Until one or the other of these terms achieves pronounced preference, the committee makes no recommendation as between them. It approves the use of the term in accounting language in connection with the concept of ability to realize net income.

Committee on Terminology (1954-1955)

EDWARD B. WILCOX, *Chairman*
ALMAND R. COLEMAN
CLIFFORD V. HEIMBUCHER

Accounting Terminology Bulletin No. 3

BOOK VALUE

AUGUST, 1956

1. The term *book value* is one of several widely used expressions in which the word *value* appears with a particular qualifying adjective to denote a particular concept of value. *Book value* is to be distinguished from such terms as fair or market value or liquidating value, in that it refers to amounts reflected on accounting records and in financial statements.

2. The term *book value* is seldom if ever used in the body of financial statements, either as an indication of the basis of stating an item therein or in connection with owners' equities. To do so would involve a pointless truism and such use is therefore not recommended.

INDIVIDUAL ITEMS

3. In Accounting Terminology Bulletin No. 1, the term *value* is defined as follows:

> *Value* as used in accounts signifies the amount at which an item is stated, in accordance with the accounting principles related to that item. Using the word *value* in this sense, it may be said that balance-sheet values generally represent cost to the accounting unit or some modification thereof; but sometimes they are determined in other ways, as for instance on the basis of market values or cost of replacement, in which cases the basis should be indicated in financial statements.

4. This use of the word value does not involve the concept of current worth, but rather refers to a particular method of quantitative determination.

5. The following slight rephrasing of the first sentence of the definition quoted in paragraph 3 above gives the clue to the meaning which some have adopted for book value as applied to individual items in books of account or in financial statements:

> *Book value* signifies the amount at which an item is stated in accordance with the accounting principles related to the item.

6. Thus one might refer to the "book value" or "net book value" of fixed assets, or the "book value of investments." More specific terms, however, can be used in describing the kind of value at which individual items are stated; as, for example, *cost less depreciation, lower of cost or current replacement cost,* or *lower of cost or selling price.* Similarly the term *ledger balance* or a term such as *the amount shown in published financial statements* would more clearly and accurately convey an exact meaning. The committee believes that any reference to a quantitative determination of a specific item can be more clearly and specifically described by terms other than the general and relatively vague term *book value.*

7. ***Recommendation:*** The committee recommends that the use of the term *book value* in referring to amounts at which individual items are stated in books of account or in financial statements, be avoided, and that, instead, the basis of amounts intended to apply to individual items be described specifically and precisely.

OWNERS' EQUITY

8. The committee recognizes that the term *book value* is also used in various business arrangements such as partnership agreements, contracts for sale of a business interest, and wills and trusts. For example, partnership agreements sometimes contain a provision that a deceased partner's interest may be acquired by surviving partners for an amount which is based at least in part on the "book value" of the interest. Contracts for the sale of going business concerns sometimes specify a price based on the "book value" of either the capital stock or the net assets. When used in such documents, the meaning to be ascribed to the term is a question of legal interpretation of the document and appears to depend primarily on the intent of the contracting or

other parties rather than on any accounting definition of such term. While such uses of the term are common, they have given rise to misunderstandings and can easily develop into controversies when the intention of the parties is not clear. One typical difficulty arises when there is a change in circumstances between the time when an agreement regarding "book value" was reached and the time when that agreement must be interpreted. For example, a change from the Fifo to Lifo inventory basis between those two dates would affect the equities involved. Similar situations would arise with respect to any changes in accounting policies or from business combinations, divisive reorganizations, and other comparable events. Even in the absence of such changes, questions arise as to whether "book value" was intended to mean literally amounts shown on ledger accounts or amounts so shown after correction for (a) errors, (b) departures from consistently maintained practices of the enterprise, (c) departures from established practices of the type of organization, or (d) departures from generally accepted accounting principles, or any combination of such corrections.

9. When the intent of the parties is not clear as to the use of the term *book value* in reference to owners' equity, the committee suggests the following definition:

> *Book value* is the amount shown on accounting records or related financial statements at or as of the date when the determination is made, after adjustments necessary to reflect (1) corrections of errors, and (2) the application of accounting practices which have been consistently followed.

10. ***Recommendation:*** In view of the fact that the intent of the parties to arrangements involving sale or transfer of business interests should govern, and the foregoing definition may not reflect such intent, the committee recommends that the term *book value* be avoided. Instead of this term it is recommended that any agreement involving the general concept of book value should contain a clearly defined understanding in specific and detailed terms, particularly as to such matters as are referred to in paragraph 8 of this bulletin.

Committee on Terminology (1955-1956)

Edward B. Wilcox, *Chairman*
John K. McClare
William W. Werntz

Accounting Terminology Bulletin No. 4

COST, EXPENSE AND LOSS

JULY, 1957

INTRODUCTION

1. In Accounting Terminology Bulletin No. 2 the terms proceeds, revenue, income, profit, and earnings were defined. This bulletin defines the correlative terms *cost*, *expense*, and *loss*. While ascertainment of cost sometimes involves processes of valuation and allocation, the techniques of ascertainment are not discussed here.

DEFINITIONS AND RECOMMENDATIONS

Definitions

2. *Cost* is the amount, measured in money, of cash expended or other property transferred, capital stock issued, services performed, or a liability incurred, in consideration of goods or services received or to be received. Costs can be classified as unexpired or expired. Unexpired costs (assets) are those which are applicable to the production of future revenues. Examples of such unexpired costs are inventories, prepaid expenses, plant, investments, and deferred charges. Expired costs are those which are not applicable to the production of future revenues, and for that reason are treated as deductions from current revenues or are charged against retained earnings. Examples of such expired costs are costs of products or other assets sold or disposed of, and current expenses. Unexpired costs may be transferred from one classification to another before becoming expired costs as above defined, e.g., depreciation or insurance on plant may be included in unexpired costs ascribed to inventories.

3. *Expense* in its broadest sense includes all expired costs which are deductible from revenues. In income statements, distinctions are often made between various types of expired costs by captions or titles including such terms as cost, expense, or loss, e.g., cost of goods or services sold, operating expenses, selling and administrative expenses, and loss on sale of property. These distinctions seem generally useful, and indicate that the narrower use of the term *expense* refers to such items as operating, selling or administrative expenses, interest, and taxes.

4. *Loss* is (1) the excess of all expenses, in the broad sense of that word, over revenues for a period, or (2) the excess of all or the appropriate portion of the cost of assets over related proceeds, if any, when the items are sold, abandoned, or either wholly or partially destroyed by casualty or otherwise written off. When losses such as those described in (2) above are deducted from revenues, they are expenses in the broad sense of that term.

Recommendations

5. The term *cost* should be used when appropriate in describing the basis of assets as displayed in balance sheets, and properly should be used in income statements to describe such items as cost of goods sold, or costs of other properties or investments sold or abandoned.

6. While the term *expense* is useful in its broad and generic sense in discussions of transactions and as a general caption in income statements, its use in financial statements is often appropriately limited to the narrower sense of the term as indicated in paragraph 3. In any event, items entering into the computation of cost of manufacturing, such as material, labor, and overhead, should be described as costs and not as expenses.

7. The term *loss* should be used in financial statements in reference

to net or partially net results when appropriate in place of the term income or profit as described in paragraphs 8, 9, and 10 of Accounting Terminology Bulletin No. 2. In such cases the term should generally be used with appropriate qualifying adjectives. It should also be used in describing results of specific transactions, generally those that deal with disposition of assets. The use of the term in the latter type of cases is believed desirable since it distinguishes them from more normal expenses of a recurring type which are generally shown in gross amounts.

Committee on Terminology (1956-1957)

EDWARD B. WILCOX, *Chairman*
JOHN K. MCCLARE
HERBERT E. MILLER